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FEDERAL CREDIT REFORM AND BORROWING BY OFF-BUDGET AGENCIES

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS HOUSE OF REPRESENTATIVES

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

APRIL 18, 1989

Serial 101-39

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FEDERAL CREDIT REFORM AND BORROWING BY OFF-BUDGET AGENCIES

TUESDAY, APRIL 18, 1989

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The committee met, pursuant to notice, at 11:08 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

[The press release announcing the hearing follows:]

FOR IMMEDIATE RELEASE
WEDNESDAY, MARCH 22, 1989

PRESS RELEASE #10
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-1721

THE HONORABLE DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES A PUBLIC HEARING ON FEDERAL CREDIT REFORM AND BORROWING BY OFF-BUDGET AGENCIES

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, today announced that the Committee will hold a public hearing to review Federal debt management policies and their effect on the budgeting and cost of Federal borrowing. The hearing will be held on Tuesday, April 18, 1989, in the Committee's main hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.

In announcing this hearing, Chairman Rostenkowski stated: "In an era of tight budgetary restraints on Federal spending, I am concerned that manipulation of Federal credit activities is becoming an inefficient, backdoor way of Federal spending and borrowing. In particular, the Committee will look into the growth of borrowing by government-sponsored enterprises, and the effect of this borrowing on the potential risk exposure of the Federal government and the cost of Federal borrowing. The Committee will look at these issues with specific reference to the government-sponsored enterprise proposed in H.R. 1287 and S. 413, the Administration's proposal to assist insolvent savings and loan institutions."

SCOPE OF THE HEARING:

Since 1974, Federal agencies have generally conducted their borrowing activity through the Federal Financing Bank (FFB), an arm of the U.S. Treasury Department. Agencies borrow from the FFB, and in turn the FFB or the Treasury Department sells notes and bonds to the public. By rationalizing Federal borrowing, this practice has allowed significantly less expensive borrowing by Federal agencies than did the former uncoordinated system.

In recent years, the FFB's role in rationalizing borrowing for Federal purposes has been significantly modified by the growth of direct public borrowing by quasi-private government-sponsored enterprises (GSEs). The securities issued by these enterprises tend to have distinct advantages over the debt issued by strictly private enterprises. Often, GSE securities can be held by Federally-regulated financial institutions under circumstances where private securities cannot; their securities can be used as collateral for public deposits; GSEs and the interest on their debt securities are often exempt from Federal taxation; and GSE's may have the authority to borrow from the Federal government. In specific instances, certain GSE's may receive even more significant benefits, such as a partial or total Federal guarantee of their securities.

As a result of these attributes, the debt obligations of certain GSEs, while not Federal debt, tend to be perceived by the financial markets as carrying an implicit Federal guarantee. In its hearing, the Committee will examine the extent to which these obligations have the same effect as issues of Federal debt. For example, the Committee will look at the extent to which GSE obligations increase the cost of Federal borrowing, and increase the overall risk exposure of the Federal government. The Committee will further examine under what circumstances GSE's should be treated for Federal budget purposes as issuers of Federal agency debt; for example, the circumstances under which such institutions' activities should be recorded on the Federal budget, their securities be subject to debt ceiling or other credit controls, and their borrowing be conducted directly through the FFB or Treasury Department.

In addition, the Committee will examine these issues with specific reference to the Resolution Financing Corporation (REFCORP), a GSE recently proposed by President Bush as part of the Administration's proposal to assist insolvent savings and loan institutions (H.R. 1287 and S. 413). As proposed, REFCORP is an off-budget GSE which would issue its debt directly to the public. Under the proposal, the Treasury Department is required to pay any interest on REFCORP obligations which REFCORP itself is unable to pay.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD:

Individuals and organizations interested in presenting oral testimony before the Committee must submit their requests to be heard by telephone to Harriett Lawler or Diane Kirkland [(202) 225-1721] no later than Thursday, April 6, 1989, to be followed by a formal written request to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The Committee staff will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Committee [(202) 225-1721)].

In view of the limited time available to hear witnesses, the Committee may not be able to accommodate all requests to be heard. Those persons and organizations not scheduled for an oral appearance are encouraged to submit written statements for the record of the hearings. All persons requesting to be heard, whether they are scheduled for oral testimony or not, will be notified as soon as possible after the filing deadline.

Witnesses scheduled to present oral testimony are requested to briefly summarize their written statements. The full statement will be included in the printed record.

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, all witnesses scheduled to appear before the Committee are required to submit 100 copies of their prepared statements to the Committee office, room 1102 Longworth House Office Building, at least 24 hours in advance of their scheduled appearance. Failure to comply with this requirement may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Persons submitting written statements for the printed record of the hearing should submit at least six (6) copies by the close of business, Tuesday, May 2, 1989, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements for the record of the printed hearing wish to have their statements distributed to the press and the interested public, they may provide 100 additional copies for this purpose to the Subcommittee office, room 1111 Longworth House Office Building, before the hearing begins.

SEE FORMATTING REQUIREMENTS BELOW:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

Chairman ROSTENKOWSKI. The committee will come to order.

I want to apologize, but there was an emergency caucus of the Democratic majority. And under our rules, when there is a caucus, which is still going on, the Chair is not permitted to convene the committee. I am probably in violation of those rules right now, but Mr. Mullins, I know that you have to go, have to leave, so I would like to get on record your testimony. And I want my colleagues to understand that we are going to try to work in some limited constraints. The committee is meeting with the Korean Minister at noon so I just want my colleagues to understand that.

Today we will hear testimony on an issue of recurring significance to the Committee on Ways and Means. Among its other responsibilities, this committee has jurisdiction over Federal debt management policy. If the Federal Government raises money by borrowing it rather than taxing it, this committee has the responsibility of overseeing that this borrowing is accomplished with the greatest possible efficiency and the least possible cost.

Today, the committee will hear testimony on the debt management issues raised by Government-sponsored enterprises or GSE. GSE's are quasi-private institutions that issue debt that is more favorably treated than the debt of private businesses. For example, the GSE borrowing is typically and implicitly, or explicitly, guaranteed by the Federal Government. In addition, a GSE may have a direct line of credit with the Treasury Department.

RefCorp, the financial institution created under the administration's plan to assist troubled thrift institutions is the most recently proposed GSE.

Because of the Federal backing given to their borrowing, GSE's have posed troubling budget and debt management questions, under what circumstances should GSE's be treated as on-budget Federal agencies, under what circumstances should their borrowing be conducted through the Federal Financing Bank, like Federal agency borrowing. What is the cost to the Federal Government of treating entities that operate like Federal agencies as private institutions?

The committee will be particularly interested in examining these issues with respect to RefCorp. Under the administration's proposal, RefCorp is treated as an off-budget entity. Its securities are sold directly to the public rather than through the Treasury Department.

The repayment of principal on these bonds is not recorded on the Federal budget. The committee will explore whether the proposed treatment of RefCorp debt is the most prudent and most effective way of raising these funds.

I am pleased to welcome our first witness, David Mullins, Assistant Secretary for Domestic Finance of the Treasury Department.

Mr. Mullins, I understand that it is necessary for you to attend the Senate floor debate on the savings and loan bill now under consideration. In the interest of allowing you to conclude your appearance here as quickly as possible, I would ask that you please summarize your testimony and focus on those aspects related to GSE's and RefCorp. We will try to keep the questions to a minimum, and will submit any further additional questions in writing.

Mr. Mullins, if you are ready to proceed, the committee is ready to accept your testimony.

STATEMENT OF HON. DAVID W. MULLINS, JR., ASSISTANT SECRETARY OF THE TREASURY [DOMESTIC FINANCE]

Mr. MULLINS. Thank you, Mr. Chairman.

It is a pleasure to be here. I welcome this opportunity to participate in your examination of Federal credit reform and borrowing by off-budget agencies.

In the interest of time, I will summarize my statement, as you requested, and submit the full statement for the record. I shall also focus primarily on the questions which were submitted to us.

You specifically requested our assessment of four issues posed by borrowing activities of GSE's generally.

Question No. 1: Does GSE credit activity pose risks to the Federal Treasury? We believe the answer is yes, both directly and indirectly. Several GSE's have the authority to borrow from Treasury in amounts that range up to $4 billion. These authorities would presumably be used if the institutions became financially impaired or otherwise became unable to honor their private market obligations. Some obligations issued by GSE's are guaranteed by the Government. The Treasury is required by law to pay a significant portion of the interest obligations of one GSE. Moreover, participants in the Federal agency securities markets have long held the view that Congress would not permit GSE's to fail. This creates the perception in the financial marketplace of an implicit Federal guarantee behind GSE debt. Recent congressional actions with respect to the farm credit system have reinforced this view.

In view of the potential taxpayer exposure to risks undertaken by GSE's, the committee might want to ask some Federal entity, such as CBO or GAO, to study the relationships between risks and GSE capital to consider whether capital standards should be established for GSE's. Currently, the GSE's ties to the Government permit them to operate with high ratios of liabilities to capital compared with private enterprises, particularly when liabilities for mortgage-backed securities are taken into consideration. Such a study could address whether financial institution type capital standards would be appropriate for GSE's, since GSE's perform intermediation functions that are similar to those of financial institutions. The study could look into what existing or new Federal entity within the Federal Government should set the capital standards, and also address whether uniform capital standards for all GSE's would be appropriate, or whether the operations are sufficiently unique to require differentiated standards. The study could also explore whether there is a need for routine analysis and reporting of the financial condition of GSE's by some Federal entity.

Question No. 2: Can GSE borrowing raise the cost of Federal borrowing and, if so, under what conditions?

The total volume of credit available in financial markets at any time is limited by a number of constraints, including the flow of savings and investments, and the constraints of monetary policy and the level of interest rates. Treasury borrowing is subject to oversight. Treasury borrows to finance outlays authorized explicitly

by Congress, and the aggregate amount of outstanding Treasury debt is limited by law. The borrowing activities of many GSE's are not so constrained. The limited supply of credit available in the economy means that increased demands from incremental borrowing, borrowing which would not otherwise take place, of GSE's may add to pressures on interest rates, and may tend to raise interest costs for all borrowers, including the Federal Government. These problems may be especially acute during periods of increased economic activity when private demands for capital rise.

Question No. 3: What information is available to Congress and the administration on the extent of actual and contingent Federal liabilities created by GSE borrowing?

Although it is not presented and summarized succinctly in a centralized fashion, there is ample useful information in the budget on Federal liabilities associated with GSE borrowing. I have more detail on the information available in my written statement.

No. 4: Under what circumstances are credit activities more appropriately conducted for budget and management purposes as on-budget borrowing by Federal agencies, rather than GSE's?

The question of appropriate Federal credit program management structures is distinct from the question of the appropriate budget scoring of Federal credit activities.

Federal credit assistance programs are created primarily to address two objectives: First, to provide subsidies to particular borrowers and, second, to correct capital market imperfections and increase the amount of credit available for specific purposes. From a management perspective, it is with respect to the first objective that the need for direct Federal intervention and control is the greatest. Thus, the subsidy objective has generally been addressed by programs of direct Federal loans and Federal loan guarantees, and GSE's have traditionally been created to improve the private market mechanism.

There are a number of considerations involved in determining the appropriate budget scoring for Federal credit activities. These considerations are addressed by OMB in preparing the President's budget and by CBO in preparing the congressional budget.

Mr. Chairman, you have also requested our response to two questions specific to RefCorp, the proposed financing vehicle to fund the resolution of insolvent S&L's.

RefCorp Question No. 1: As proposed, is RefCorp structured more like an off-budget agency, or like a GSE?

RefCorp is structured to be a Government sponsored enterprise rather than a Government-owned enterprise and, therefore, it is excluded from the budget. Under our bill, RefCorp is a limited purpose GSE chartered by the Chairman of the Federal Home Loan Bank System. RefCorp bonds are not Treasury obligations and are not guaranteed by the Treasury. Private capital is used to fully repay the principal on all debt issued. There is no set of circumstances which would require Treasury funds to repay RefCorp principal. Moreover, industry funds are also used to pay interest costs with Treasury paying any shortfall. Every dollar of Treasury funds expended is scored on budget in the year expended, and there is no hidden or contingent Treasury liability associated with RefCorp.

RefCorp Question No. 2: What are the benefits and costs to the Government of providing that RefCorp issue its own debt to the public, rather than rely exclusively on Treasury borrowing?

RefCorp is a special purpose financing vehicle. It has a distinct limited life to resolve a specific problem. If enacted as proposed, Congress will limit the amount that RefCorp can borrow and provide it with no line of credit to the Treasury. We believe this type of vehicle is appropriate because it is the best way to assure that the S&L industry pays a substantial portion of the cost to resolve its own problems. Under our plan, Federal home loan bank earnings and S&L assessments completely cover the repayment of principal on all debt issued, as well as a portion of the interest. This industry self-help feature would be jeopardized with Treasury financing since industry funds would not be required specifically to repay Treasury debt or meet Treasury interest payments.

In addition, the RefCorp financing mechanism requires separate and distinct accounting for all costs associated with the administration's plan, and facilitates a precise traceable accounting of all public and private funds employed in the plan. In contrast, with direct Treasury funding, accountability is obscured since the financing cost of the administration's plan is buried within the cost of financing and refinancing the Federal debt.

Finally, Treasury financing of the plan would result in large increases in the Federal deficit in 1990 and 1991, making it virtually impossible to meet the legislated Gramm-Rudman-Hollings deficit targets. Alternative financing plans create budgetary loopholes which undermine either the letter or the spirit of the Gramm-Rudman-Hollings target's discipline and thus set dangerous precedents with serious implications for financial markets.

We firmly believe that any potential cost savings from direct Treasury borrowing would be more than offset by the cost of delay, the loss of significant up-front industry contributions, and the possible costs of a market reaction to a rupture in the Gramm-Rudman-Hollings discipline.

Mr. Chairman, this concludes my summary. I will be glad to answer any questions you or the committee may have at this time.

[The statement of Mr. Mullins follows:]

FOR RELEASE ON DELIVERY
EXPECTED AT 11:00 A.M.
April 18, 1989

STATEMENT OF THE HONORABLE
DAVID W. MULLINS, JR.
ASSISTANT SECRETARY OF THE TREASURY
(DOMESTIC FINANCE)
BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS

Mr. Chairman and Members of the Committee:

I welcome the opportunity to participate in your examination of Federal credit reform and borrowing by off-budget agencies. I also want to take this opportunity to seek your support of the Administration's credit reform proposal, H.R. 1127.

Over the years the Treasury has been involved in a number of policy initiatives designed to control the growth and cost of Federal and federally-assisted credit. The Federal Government is the largest financial intermediary in the United States. At the end of 1988, the Government held $222 billion of outstanding direct loans (including $124 billion financed by the Federal Financing Bank) and had another $550 billion in outstanding guaranteed loans (including $451 billion of FHA and VA mortgages and $48 billion of guaranteed student loans). Government-sponsored enterprises, such as the Federal National Mortgage Association and the Federal Home Loan Banks, had an additional $666 billion of outstanding loans at the end of the year. Thus, directly or indirectly, the Government had influenced the allocation of $1.4 trillion of outstanding credit to farmers, homeowners, small businesses, exporters, utilities, shipbuilders, and State, local and foreign governments.

While much public attention is focused on direct Treasury borrowing to finance budget deficits, much less attention has been focused on federally-assisted borrowing in the form of off-budget guaranteed loans and borrowing by off-budget Government-sponsored enterprises. Yet, of the estimated $193 billion of net Federal and federally-assisted borrowing in FY 1990, 46 percent is for financing the budget deficit, 17 percent for financing off-budget Federal loan guarantee programs, and 37 percent for financing off-budget GSEs. Taken together, it is clear that off-budget credit assistance from the Federal Government will be the largest component of total borrowing under Federal auspices in FY 1990.

Guaranteed borrowing

Under present budget scorekeeping, loan guarantees appear to be essentially costless at the time the guarantee is issued, regardless of how much subsidy may be implicit in the program. Additionally, some Federal guarantees underwrite debt financed in competition with direct Federal borrowing, and the impact of such borrowing is like Treasury borrowing to finance direct loans and has a similar adverse impact on private credit markets and interest rates.

A major reason for the growth in loan guarantees is the intense scrutiny given in the budget process to the deficit in the up-coming budget year. Loan guarantees have a negligible impact on the budget deficit in the year in which the guarantee is issued. That is, unlike direct loans which result in immediate budget outlays in the full amount of the disbursement,

loan guarantees are reflected in the unified budget outlay totals only over time, to the extent of program administrative expenses, the cost of future defaults, and in some cases, direct cash interest subsidies. Thus, guarantees provide significant benefits to borrowers with substantially less near-term budget impact than providing the same level of benefits in the form of direct loans. Consequently, there has been a marked shift from direct to guarantee loan programs by those wanting to expand Government programs with minimal near-term budget effect. In addition, there has been a pronounced shift from Government guaranteed debt financed by local lending institutions to debt financed directly in the securities market. These trends have contributed to the significant growth in guarantee programs which has occurred over the last decade.

While the problem of the budget treatment and control of guaranteed loans has remained unsolved, considerable progress has been made with respect to the efficient financing of Federal credit programs.

Federal Financing Bank

At the request of the Treasury, the FFB was established by Congress in 1973 to deal with severe debt management problems resulting from years of off-budget financing which had flooded the Government securities market with a variety of Government-backed securities. These securities were financed outside the Treasury by various Federal agencies in the form of direct agency issues, sales of loan assets with Federal guarantees, and guarantees of obligations of private borrowers. Although the securities were backed by the Government, they sold at relatively high interest rates and fees. These securities also competed with Treasury securities, undermined Treasury debt management policies, created serious marketing problems, and placed Treasury in a position of acquiescing to agency financings on terms which Treasury believed did not reflect the full value of the Government backing.

The FFB was a response to a need for control and rationalization of the financing of Federal programs, primarily credit assistance programs. This need arose from three basic trends: (1) the rapid growth of Federal credit assistance programs, (2) the shift from direct loans (on-budget) to guaranteed loans (off-budget), and (3) the shift from guaranteed loans financed by local lending institutions to guaranteed obligations financed directly in the securities markets.

The proliferation of the Government-backed securities in the market before the establishment of the FFB was very costly to the Government, and thus the taxpayer, in part because of higher transaction costs and in part because the less competitive market for the securities resulted in higher borrowing costs. For example, prior to the establishment of the FFB, obligations fully guaranteed by the Department of Defense under the foreign military sales program were financed in the securities markets at interest rates up to 2 percentage points over prevailing market yields on Treasury securities of comparable maturity. Since there is no economic difference between a guaranteed loan and a direct loan by FFB or another Federal agency, there is no reason to incur higher costs to the Government for financing guarantee programs in the private markets.

It is now widely recognized that the FFB has been successful in rationalizing Federal borrowing activity. Twenty-seven Federal agency programs of issues, sales, or guarantees of securities, totaling $146 billion of obligations outstanding at the end of FY 1988, have been financed by the FFB. (See attachment.) The consolidation of market financing by the FFB has resulted in estimated savings in program financing costs of well in excess of $1/2 billion per year, most of which are

savings to the Government rather than to guaranteed borrowers.

While the FFB's primary function is debt management, the FFB has also served to facilitate the control of Federal credit programs. By consolidating the borrowing of the various agencies, the FFB has made the problem of unrestrained growth in Federal credit more visible and has underscored the need for more effective control. In addition, the FFB has served to bring to the attention of Congress the true nature and aggregate impact of these programs and has led to many Congressional hearings and studies concerning the control of Federal credit programs.

Budget status

Until 1985, the outlays of the FFB were off-budget, including its purchases of guaranteed loan assets from Federal agencies and its direct loans to private borrowers guaranteed by Federal agencies. Because of its off-budget status, the FFB was sometimes wrongly criticized for being in itself a means for Federal agencies to avoid budget control of their credit programs. The FFB, however, was created strictly for the purpose of reducing the costs of Federal and federally-assisted borrowing from the public, and to assure that such borrowings are financed in a manner least disruptive of private financial markets and institutions. The FFB itself did not affect either the budget status or the authorized program levels of the agencies using the FFB. The actual allocation of budget and credit resources to various agencies and programs is determined through the budget process. Any efforts to control credit programs should be focused on the programs themselves, rather than on the FFB.

The off-budget status of the FFB was one of the issues considered in 1981 and 1982 by the Reagan Administration, when the Federal Credit Policy Working Group under the auspices of the Cabinet Council on Economic Affairs (now known as the Economic Policy Council) conducted an extensive review of the FFB in the broader context of overall Administration budget and credit program policies. That review led to the adoption of two important principles. First, the budget should include all of the Government's cash outlays to the public, including outlays to the public by the FFB, and second, all agencies should, over time, be required to finance fully guaranteed securities of a type that is ordinarily financed in investment securities markets through the FFB rather than in the securities market.

In accordance with the second principle, OMB Circular No. A-70, "Policies and Guidelines for Federal Credit Programs," re-issued in August 1984, included a requirement that fully guaranteed obligations of a type that is ordinarily financed in investment securities markets be financed by the FFB. At Treasury's request, this requirement was also included in the legislation submitted by the Reagan Administration to Congress in July 1985 to implement the first principle. If the legislation were enacted to place the FFB on-budget without the requirement, it was expected that Federal agencies would simply bypass the FFB by financing their fully guaranteed obligations directly in the securities market in order to avoid budgetary control of their credit programs. The legislation which emerged from Congress, Gramm-Rudman-Hollings, did not include the requirement for FFB financing of fully guaranteed securities of a type that is ordinarily financed in investment securities markets.

In keeping with Federal credit program policy, the Reagan Administration's credit reform legislation, submitted to Congress in 1987, 1988 and again in January 1989, included a requirement that fully guaranteed obligations of a type that is ordinarily financed in investment securities markets be financed by the FFB. The Bush Administration has endorsed the credit reform legislation, which has been recently introduced as H.R. 1127 and S. 584. H.R. 1127 was introduced by Mr. Gradison and referred to

your Committee, as well as the House Banking, Government Operations, and Rules Committees. The credit reform legislation will improve the accounting for Federal credit transactions in the budget/appropriations process by requiring credit agencies to obtain appropriations to cover the estimated subsidy costs in direct and guaranteed loans. This approach will provide a basis for direct comparisons in the budget process of the economic costs of credit subsidies with the costs of subsidies provided in the form of cash grants.

Effects of GRH

Gramm-Rudman-Hollings, which was enacted in December 1985, required all transactions of the FFB on behalf of a Federal agency to be treated as a means of financing for the agency. As a result, FFB disbursements that were formerly off-budget are now scored as budget outlays of the agency originating the transaction. Thus, without the requirement that Federal agencies finance their fully guaranteed obligations through the FFB, the GRH change in budget scoring has led to intense pressure to return to the off-budget financing of guaranteed obligations in the private market. Since 1985, legislation has been enacted which prohibited FFB financing of new loans under four guarantee programs and instead, authorized private market financing with full faith and credit guarantees.

In addition, the GRH budget scoring change led to the sale with recourse of loans in the FFB portfolio in order to reduce near-term budget deficits, at the expense of higher deficits in future years. This incentive, combined with Congressional desire to provide further subsidies to certain borrowers, prompted Congress to create prepayment programs under which rural electric cooperatives and foreign governments are authorized to prepay their FFB loans at less than their contractually defined prepayment prices and to refinance privately with Government guarantees. This procedure produces a subsidy that is determined, not on the basis of an analysis of need for subsidy, but by the happenstance of changing interest rate relationships. Moreover, this subsidy (the loss in FFB loan value at prepayment) is not appropriated by Congress to the program agency, but rather, is hidden in the cost of financing the public debt. To date, these borrowers have prepaid $9 billion resulting in associated taxpayer losses of $2 billion.

More recently, in October 1988 the President vetoed a legislative proposal to permit SBA section 503 certified development companies to prepay their guaranteed borrowings from the FFB at substantially reduced premiums and to finance the prepayments with market borrowings fully guaranteed by the Government.

As a result of the shift to market financing of new loans under programs previously financed by the FFB and the disposal of loans in the FFB portfolio, FFB financing of Federal credit programs has declined from a peak of $140 billion in 1986 to $124 billion at the end of 1988, and is projected to decline further to $86 billion at the end of 1994.

GSEs

The GRH legislation has also prompted a renewed interest, after a 15-year hiatus, in the creation of off-budget Government-sponsored enterprises. Prior to GRH, the last GSE to be created was the Student Loan Marketing Association. SLMA was created in 1972 as a part of the effort described earlier to shift the financing of guaranteed loans from the bank loan market to the securities market. Beginning in 1987, four new GSEs have been created:

- The College Construction Loan Insurance Association,

created to guarantee bonds issued for college construction to fill the void which would be left by the proposed termination of on-budget direct loan programs conducted by the Department of Education.

- The Financing Corporation, created to recapitalize the Federal Savings and Loan Insurance Corporation.

- The Farm Credit System Financial Assistance Corporation (FAC), created to provide a financing mechanism for the Farm Credit System.

- The Federal Agricultural Mortgage Corporation (Farmer Mac), created to shift the financing of farm loans from the bank loan market to the securities market.

The charter of a fifth new GSE, the Farm Credit System Capital Corporation, was revoked by the legislation that created FAC and Farmer Mac.

Legislation was proposed to create a sixth new GSE, the Corporation for Small Business Investment. This legislation, which was strongly opposed by the Administration, was not adopted by the 100th Congress. COSBI would have shifted off-budget certain activities now financed on-budget by the Small Business Administration.

A seventh new entity, the Farm Credit System Insurance Corporation, was established to insure the timely payment of principal and interest on Farm Credit System obligations. This entity was initially considered to be a GSE, but upon further examination, has been classified in the Budget as a Federal agency.

The four new GSEs which have been created differ from the older, traditional GSEs. The traditional GSEs serve as financial intermediaries to facilitate the flow of credit to private borrowers in three major areas: (1) agriculture, (2) housing, and (3) higher education. The older GSEs typically have raised funds in the capital markets in their own names or by issuing pass-through securities, and then either have lent directly to their borrower clientele or have served as financial intermediaries by providing liquidity to local lending institutions. Unlike the traditional GSEs, the four new enterprises were either established primarily to assist a Federal agency or an existing GSE, or will assist the public by insurance rather than by financial intermediation.

Mr. Chairman, you have specifically requested our assessment of four issues posed by borrowing activities of GSEs generally:

1. <u>Does GSE credit activity pose risks to the Federal Treasury</u>?

   Yes, both directly and indirectly. Several GSEs have authority to borrow from the Treasury in amounts that range up to $4 billion. These authorities would presumably be used if the institutions became financially impaired or otherwise became unable to honor their private market obligations. Some obligations issued by GSEs are guaranteed by the Government, and the Treasury is required by law to pay a significant portion of the interest on the obligations of one GSE. Moreover, participants in the Federal agency securities market have long held the view that Congress would not permit GSEs to fail. Recent Congressional actions with respect to the Farm Credit System have reinforced this view.

In connection with potential taxpayer exposure to risks undertaken by the GSEs, the Committee might want to ask a Federal entity, such as the Congressional Budget Office, to study the relationship between risks and GSE capital and to consider whether capital standards should be established for the GSEs. Currently, the GSEs' ties to the Government permit them to operate with high ratios of liabilities to capital, compared with private enterprises, particularly when liabilities for mortgage-backed securities are taken into consideration. Such a study could address whether financial-institution type capital standards would be appropriate for the GSEs, since the GSEs perform intermediation functions that are similar to those of financial institutions, and what existing or new entity within the Federal Government should set the capital standards. It could also address whether uniform capital standards for all GSEs would be appropriate or whether the operations are sufficiently unique to require differentiated standards.

2. Can GSE borrowing raise the cost of Federal borrowing, and if so, under what conditions?

The total volume of credit available in financial markets at any time is limited by a number of constraints, including the flow of savings and investment, and the constraints of monetary policy and the level of interest rates. While Treasury borrowing is subject to oversight and control, i.e., Treasury borrows to finance outlays authorized by Congress, and the aggregate amount of outstanding Treasury debt is limited by law, the borrowing activities of many GSEs are not so constrained. The limited supply of credit available in the economy means that increased demands from incremental borrowings of GSEs may add to pressures on interest rates and may tend to raise interest costs for all borrowers, including the Federal Government. These problems may be especially acute during periods of increased economic activity when private demands for credit rise.

3. What information is available to the Congress and the Administration on the extent of actual and contingent Federal liability created by GSE borrowing?

Although not presented and summarized succinctly, there is much useful information in the Budget on the Federal liabilities associated with GSE borrowing. For example, the Federal Government has a contingent liability for principal and interest on approximately $5 billion of Student Loan Marketing Association obligations guaranteed by the Department of Education. The Government has an actual liability for a significant portion of the interest on obligations issued by the Farm Credit System Financial Assistance Corporation, and a contingent liability for the remaining interest and all of the principal. Beginning in FY 1993, the Government will have a contingent liability for principal and interest on Farm Credit System obligations insured by the Farm Credit System Insurance Corporation. The Budget also indicates the Government will share with the private sector ultimate financial risk with respect to the Federal Agricultural Mortgage Corporation, the Federal National Mortgage

Association, and the College Construction Loan Insurance Association.

4. Under what circumstances are credit activities more

appropriately conducted for budget and management purposes as on-budget borrowing by Federal agencies, rather than through GSEs?

The question of appropriate Federal credit program management structures is distinct from the question of the appropriate budget scoring for Federal credit activities.

Federal credit assistance programs are created primarily to address two objectives: (1) provide subsidies to particular borrowers, and (2) correct capital market imperfections and increase the amount of credit available for specific purposes. From a management perspective, it is with respect to the first objective that the need for direct Federal intervention and control is the greatest. Thus the subsidy objective has generally been addressed by programs of direct Federal loans and Federal loan guarantees, and GSEs have traditionally been created to improve the private market mechanism.

There are a number of considerations involved in determining the appropriate budget scoring for Federal credit activities. These considerations are addressed by OMB in preparing the President's budget and by CBO in preparing the Congressional budget.

Mr. Chairman, you have also requested our response to two questions specific to REFCORP:

1. As proposed, is REFCORP structured more like an off-budget agency, or like a GSE?

   REFCORP is structured to be a Government-sponsored enterprise, rather than a Government-owned enterprise, and therefore it is excluded from the budget. Under our bill, REFCORP is a limited purpose GSE chartered by the Chairman of the Federal Home Loan Bank System. REFCORP bonds are not Treasury obligations and are not guaranteed by the Treasury. Private capital is used to fully repay principal on all debt issued. Moreover, industry funds are also used to pay interest costs, with Treasury guaranteeing the payment of any shortfall. Every dollar of Treasury funds expended is scored on budget in the year expended.

2. What are the benefits and costs to the government of providing that REFCORP issue its own debt to the public, rather than rely exclusively on Treasury borrowing?

   The REFCORP is a special purpose financing vehicle. It has a distinct, limited life to resolve a specific problem. If enacted as proposed, Congress will limit the amount that REFCORP can borrow and provide it with no line of credit to the Treasury. We believe this type of vehicle is appropriate because it is the best way to ensure that the S&L industry pays a substantial portion of the cost to resolve its own problems. Under our plan, FHLBank earnings and S&L assessments completely cover the repayment of the principal on all debt issued, as well as a portion of the interest. This industry "self-help" feature would be jeopardized with Treasury financing, since industry funds would not be collected specifically to repay Treasury debt or meet Treasury interest payments.

   In addition, the REFCORP financing mechanism requires

separate and distinct accounting for all costs associated with the Administration's plan. In contrast with direct Treasury funding out of general revenues, this mechanism more easily accommodates an oversight function - such as the RTC - with direct accountability for its decisions.

Finally, Treasury financing of the plan would result in large increases in the Federal deficit in 1990 and 1991, making it virtually impossible to meet the legislated Gramm-Rudman-Hollings deficit targets. Alternative financing plans set dangerous precedents with serious implications for the financial markets.

We firmly believe that any potential cost savings from direct Treasury borrowing would be more than offset by the costs of delay, the loss of significant, up front industry contributions, and the possible costs of a market reaction to a loss of Gramm-Rudman-Hollings discipline.

This concludes my prepared statement. I will be glad to answer any questions you may have.

Attachment

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FEDERAL FINANCING BANK HOLDINGS
(in millions)

Program	September 30, 1988	FY '88 Net Change 10/1/87-9/30/88
Agency Debt:		
Export-Import Bank	$ 10,957.6	$ -1,505.8
NCUA-Central Liquidity Facility	118.1	6.8
Tennessee Valley Authority	17,131.0	745.0
U.S. Postal Service	5,592.2	1,238.8
sub-total*	33,799.0	484.7
Agency Assets:		
Farmers Home Administration	58,496.0	-6,513.0
DHHS-Health Maintenance Org.	79.5	-4.4
DHHS-Medical Facilities	96.4	-5.9
Overseas Private Investment Corp.	-0-	-0.7
Rural Electrification Admin.-CBO	4,139.2	-102.0
Small Business Administration	15.4	-4.2
sub-total*	62,826.5	-6,630.2
Government-Guaranteed Lending:		
DOD-Foreign Military Sales	16,011.7	-3,152.3
DEd.-Student Loan Marketing Assn.	4,910.0	-30.0
DOE-Geothermal Loan Guarantees	50.0	50.0
DHUD-Community Development	318.1	-6.2
DHUD-New Communities	-0-	-30.6
DHUD-Public Housing Notes +	2,037.0	-37.3
General Services Administration +	387.5	-8.0
DOI-Guam Power Authority	32.1	-1.1
DOI-Virgin Islands	26.6	-0.6
NASA-Space Communications Co. +	898.8	90.2
Navy Ship Lease Financing	1,758.9	-29.4
Rural Electrification Administration	19,205.3	-1,991.6
SBA-Small Business Investment Cos.	632.7	-107.9
SBA-State/Local Development Cos.	870.9	-28.9
TVA-Seven States Energy Corp.	2,162.4	338.7
DOT-Section 511	46.2	-9.2
DOT-WMATA	177.0	-0-
sub-total*	49,525.1	-4,954.1
grand total*	$ 146,150.5	$ -11,099.6

*figures may not total due to rounding
+does not include capitalized interest

Chairman ROSTENKOWSKI. I have just one question, Mr. Secretary.

The present value of the principal and interest on RefCorp debt is $50 billion. Only 10 percent of this will be paid for from private sources.

How do you justify putting the other 90 percent off-budget?

Mr. MULLINS. Well, first, let me say, Mr. Chairman, that I am new to the arcane world of budget accounting, and I am not an expert on that. OMB is the one who makes these decisions.

But as a finance person who just came in and looked at this problem, I think our scoring is the correct way to do it. Not a penny of Treasury funds will ever be used to pay any of the $50 billion in principal. So I don't see why the taxpayers should be charged for a principal payment that the industry will end up making. And in fact I would be concerned if we were to charge the taxpayer with the $50 billion in principal because I'm afraid if we charge the taxpayer with the $50 billion, they are going to end up paying the $50 billion.

So the way I understand the logic is that since the industry is going to pay the $50 billion in principal, the principal should not be scored and every commitment of Treasury funds in this plan will be scored when expended.

Chairman ROSTENKOWSKI. Mr. Downey.

Mr. DOWNEY. Mr. Chairman, I don't have a question. I just have a comment.

My concern is, and I thank Mr. Mullins for his testimony, that this process of RefCorp financing appears to me to be putting off on another generation some of the sins of this generation, and maybe you can assuage my concern about that.

Mr. MULLINS. Yes, Congressman Downey.

Our belief is that that problem is minimized by our plan because the $50 billion in principal, when it comes due in 25 to 30 years, is not paid by the taxpayer. We have locked away industry funds which will grow with compound interest to pay off the principal.

If we do it with direct Treasury financing, I am concerned that we will never know when the principal is paid off because when those Treasury bonds come due, they are simply refinanced for future generations year in and year out.

So part of our concern is to try to say to people we're going to make the industry pay that $50 billion. It is true that the significant portion of the interest will be spread out through time on the RefCorp financing, but we believe that not putting that principal payment in the future on the taxpayer makes our plan less vulnerable to the concern about putting this on the backs of future generations.

Mr. DOWNEY. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Gradison.

Mr. GRADISON. Mr. Mullins, I understand that RefCorp is planning to acquire some zeroes, is that correct?

Mr. MULLINS. Yes.

Mr. GRADISON. How many?

Mr. MULLINS. Mr. Gradison, it will depend upon the interest rates. RefCorp will purchase however many zero coupon bonds are necessary to defease, to completely pay off, the principal in 30

years. The estimate in the OMB budget, OMB submissions on this were about $6 billion in——

Mr. GRADISON. Of market value?

Mr. MULLINS. Of market value in zeroes purchased with industry funds at current interest rates, the commitment would be somewhat less, perhaps on the order of $4 billion or so of zeroes purchased.

Mr. GRADISON. Would these be purchased from existing strip bonds in the market or from a new issue of zeroes by the Treasury?

Mr. MULLINS. We have not moved forward to finalize the operational details of how this will work. We are just submitting the legislation in which both options would be available to us. And we would hope, as this legislation moves forward, to put forth a proposal. So we really haven't made a decision on whether the zeroes would be purchased in the secondary market or be issued directly by Treasury.

Mr. GRADISON. If they were issued directly by Treasury and the current market were $4 to $6 billion and the face were $50 billion, would that count against the $50 billion of remaining debt limit authority?

Mr. MULLINS. The way the debt limit scoring works currently, as I understand it, Congressman Gradison, the zero coupon bonds would be scored at the face amount. So, in spite of the fact the market value is only $6 billion, it would be scored against the debt limit at $50 billion.

This is again an arcane way of doing it, and the scoring and the Federal debt ceiling calculations have been a barrier to a number of innovative types of securities, such as zero coupon bonds and other sorts of securities. One thing we might consider is whether we should switch debt ceiling scoring to some sort of accrual basis which more correctly reflects the market value of those issues and the added interest through time. But currently it would be a problem for our debt ceiling.

Mr. GRADISON. How much would that accelerate the time at which the current debt limit ceiling will be breached? I think we've been operating on the assumption it would be in August or September?

Mr. MULLINS. Congressman Gradison, I wouldn't have a specific estimate of that. I think we will meet the debt ceiling sometime this summer. And it is true that $50 billion is a large number. That is, the ceiling is now $2.8 trillion. We are currently probably at $2.75 trillion. So it's a significant amount.

Mr. GRADISON. The Treasury and OMB have been projecting that interest rates are going to go down.

Why do you want to borrow long in a market like that?

Mr. MULLINS. You mean for the RefCorp bonds?

Mr. GRADISON. Yes.

Mr. MULLINS. In general, our approach to financing does not try to predict rates and be opportunistic and take advantage of expectations because we're kind of large to do that. It is tough to dance if you are an elephant.

We feel that cleaning up this problem and putting the industry on a sound basis, financial basis, for the future is a long-term task. We would like to fix the cost of that task. If we would try to do it

with shorter term debt, we would have to continue to roll over those securities. We would be subject to interest rate risk. Again, our method allows the industry to pay the principal.

If we did it shorter term, it would be more difficult to have industry contributions. And Treasury might have to pay some of the principal.

Mr. GRADISON. Finally, I would like to read to you a paragraph, a short paragraph, from a letter, dated April 7, from Merrill Lynch to Senator Garn, related to this point of the long-term borrowing.

Mr. MULLINS. Right.

Mr. GRADISON. And I quote:

> In our opinion, the distributional problems associated with significant larger Treasury offerings would push long-term yields up at least 50 basis points. Since this incremental cost is spread out, not only on the additional monies to fund the thrift resolution but on all long-term monies raised by the Treasury Department, the total cost to the taxpayer would increase by at least $500 million a year.

I would like your comments on that.

Mr. MULLINS. I think the letter refers, Mr. Gradison, to direct Treasury financing all in fiscal 1989 rather than a RefCorp financing and, moreover, to the concern that if we did it with direct Treasury financing, we would create a budgetary loophole through Gramm-Rudman-Hollings, which would be easily replicated, and we would have more long-term financings of problems such as this.

Mr. GRADISON. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. McGrath.

Mr. MCGRATH. Thank you, Mr. Chairman.

I am sort of gratified that a hearing on this subject has come up. I was not of the impression that the universe of indebtedness through these GSE's was anywhere near what I believe it is today. Somebody just told me it is somewhere in the neighborhood of $720 billion, and we are going to be adding to that through the institution of another GSE in RefCorp somewhere I guess in the aggregate of $200 billion a year of recurring debt.

I am wondering whether or not anybody has a great handle on this? This seems to me an unbelievable amount of debt that is off-budget and, frankly, in my judgment, scattered out in terms of perusal by any members or committees of the Congress.

It seems to me that our committee has a large role in this but, at the same time, it's spread out through banking and through agriculture and a lot of other committees that have other jurisdictions and other problems where they may not necessarily focus as much as they should on this particular problem. I am just wondering whether or not we need to get a handle on this. Somebody ought to be focusing on this particular problem because of the enormous amount of growth in the outstanding debt.

Mr. MULLINS. Yes, Congressman McGrath.

First, I would point out that RefCorp is somewhat different from most traditional GSE's which are going to continue forever, and are under the control—the borrowing is under the control of a board which is in the majority private.

RefCorp is an explicit special purpose financing vehicle. The more general question, though, is it a concern? As I mentioned in my testimony, I would propose a study which is not done by the programs that are involved but rather done from the point of view

of Federal debt policy to look at the total costs and financial conditions across all GSE's.

There is concern that the marketplace believes these GSE's have an implicit backing of the Federal Government. There is concern because, for most of these GSE's, we do not have direct control over the amount of debt they issue.

There is also a concern, because many of these GSE's serve as competition for private intermediation activities which could develop.

It is true that the majority of borrowing under Federal auspices in fiscal 1990 will not be through direct Treasury financing for the deficit. So I think it's worthwhile at this stage to look systematically from a debt management point of view across all the GSE's. I am not saying that they have not done a good job. They have served constituents in housing, agriculture, and higher education. And in some cases, they have helped through securitization in making the capital markets more efficient and pioneering the way in securitization. But it has grown to a stage in which we think it would benefit from a systematic look. We are wondering whether or not someone ought to set minimum capital standards for all these institutions.

So I welcome your concern.

Chairman ROSTENKOWSKI. Mr. Sundquist.

Mr. SUNDQUIST. Pass, Mr. Chairman.

Chairman ROSTENKOWSKI. Thank you very much, Mr. Secretary. Thank you for joining us.

Mr. MCGRATH. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Bowsher. Mr. Socolar. Mr. Wolf.

Welcome, gentlemen, to the committee. You all know what our format is here.

Mr. Bowsher, if you would to begin the testimony, the committee is ready to receive it.

STATEMENT OF HON. CHARLES A. BOWSHER, COMPTROLLER GENERAL, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY MILTON J. SOCOLAR, SPECIAL ASSISTANT TO THE COMPTROLLER GENERAL AND FREDERICK D. WOLF, ASSISTANT COMPTROLLER GENERAL FOR ACCOUNTING AND FINANCIAL MANAGEMENT MATTERS

Mr. BOWSHER. Thank you very much, Mr. Chairman, and members of the committee.

I would appreciate if the full statement could be made a matter of the record, and I would just summarize some parts of it.

Chairman ROSTENKOWSKI. The Chair will make the point that all of the witnesses' testimony in full will be included in the record if they care to summarize. That will be fine, Mr. Bowsher.

Mr. BOWSHER. We are very pleased to appear before you today to discuss the Government-sponsored enterprises known as GSE's, and to address in particular the administration's proposal to establish a Resolution Funding Corporation, RefCorp, as a GSE to help resolve the current crisis in the savings and loan industry.

My statement will provide an overview of GSE's and discuss the budget treatment of GSE's, and finally provide GAO's views on

whether RefCorp, if established as currently described in draft legislation, should be treated in budget documents as an on-budget Federal corporation or, as envisioned by the administration, as an off-budget GSE.

I should preface my remarks by saying that in recent testimony on the savings and loan problem, we have said that any use of Federal money to resolve the problem should be on-budget even if that means that the Gramm-Rudman-Hollings deficit targets must be changed.

Just a quick overview of GSE's. GSE's are chartered by the Federal Government pursuant to legislation, and they traditionally have been privately owned. Most current GSE's were established to buy and sell blocks of financial assets, primarily loan securities, to increase credit availability to certain target groups, such as home buyers, farmers, and students.

The GSE's reflect a variety of organizational and financing approaches. However, there are three features common to most GSE's that I would like to discuss.

First, they generally have private financing. Most do not receive direct appropriations.

Second, they generally have mixed private and governmental control, but lean toward private control of the Board and employees. At the same time you have to recognize that they are authorized by Federal legislation and they are chartered by the Government.

Third, concerning the Government benefits that are generally given to a GSE, it generally includes a line of credit from the Treasury, which is not used by some of them. They are exempt from State and local taxes, and they are exempt from SEC oversight.

And as far as their budget treatment, the GSE's are not included in budget totals or in the Gramm-Rudman-Hollings process. This goes back to the off-budget approach recommended by the President's Commission on Budget Concepts in 1967, which stated that GSE's should be excluded because of their essentially private nature.

Now, if we go to RefCorp, I would like to summarize that a little bit here. It would be an off-budget GSE, established to raise funds for a new on-budget corporation called RTC, the Resolution Trust Corporation.

RefCorp would borrow $50 billion and transfer those proceeds to RTC. The S&L industry would raise about $5 to $6 billion as capital for RefCorp, and RefCorp would use the $5 to $6 billion to purchase 30-year zero coupon Treasuries that, upon maturity in 30 years would provide $50 billion to pay off RefCorp's debt principal.

The Federal Government must pay through the Treasury that portion of RefCorp's interest payments on its $50 billion debt not covered by the proceeds of asset sales and other industry amounts available to RefCorp.

The administration says that RefCorp is privately owned, and therefore should be excluded from the budget and Gramm-Rudman-Hollings.

I would like to point out that RefCorp's $50 billion transfer to the RTC would be treated by the Office of Management and Budget

(OMB) as private GSE money flowing to a Federal agency and therefore, as an offsetting Federal collection negative outlay. This would offset RTC's expenditures and lessen the short-term deficit impact, but the Treasury's and taxpayers' long-term interest costs on the borrowed $50 billion would run higher, as much as 25 basis points higher according to the administration, because of this type of financing.

Now, if on-budget, there is no question that you would have to raise the Gramm-Rudman-Hollings' targets, and people have debated that issue as to what effect that would have on the financial markets. The administration is claiming that it would have a negative effect. Other people are not so sure. Our own thinking is that the people on Wall Street understand this point well and probably have discounted it.

So then we come to the issue—Should RefCorp be considered a GSE? When you address this, you have to look at two issues, which we have done generally in these cases: you look at the ownership and the transactions. And under ownership, the three members of the Board would come from private institutions, and the capitalization of $5 to $6 billion would come from the private sector—S&L's—but most of the money really would come from the taxpayers.

Most of RefCorp's interest costs over the years, or about $80 billion, will be from the taxpayers, and so the Congress and the administration are both, I think, considering very close oversight by the Congress and the oversight board of this institution, and the Federal Government is assuming a real legal liability for a part or all of these RefCorp interest costs.

Now, if you also look at the transactions, which I think is the more crucial thing, then we come to the conclusion, Mr. Chairman, that RefCorp is being used as a part of the solution to the savings and loan crisis, and it should be on budget as a Federal corporation.

We have reached this conclusion after considering both the ownership and the substance of its transactions. It is especially clear to us that the substance of RefCorp's activities is governmental. It is designed solely to raise funds for a Federal corporation to satisfy Federal obligations to the American public, and it relies upon tax-like collections from industry sources.

We are concerned about the growing number of proposals to establish off-budget entities to carry out governmental functions. These proposals, whose apparent purpose is usually to avoid the discipline required by constrained budget resources, are a serious threat to the integrity of the Government's budget in financial management systems.

If the proliferation of such entities continues, it will raise grave doubts about the credibility of the Government's reports on its financial operations and conditions, making it even more difficult for decisionmakers and the public to understand and to deal meaningfully with the overriding problem of our budget deficit.

Mr. Chairman, that concludes our prepared remarks. We would be happy to answer any questions.

[The statement of Mr. Bowsher and an attachment follow:]

**STATEMENT OF CHARLES A. BOWSHER-
COMPTROLLER GENERAL OF THE UNITED STATES**

Mr. Chairman and Members of the Committee:

I am pleased to appear before you today to discuss government-sponsored enterprises, known as GSEs, and to address in particular the administration proposal to establish a Resolution Funding Corporation (REFCORP) as a GSE to help resolve the current crisis in the savings and loan industry. My statement will provide an overview of GSEs, discuss the budget treatment of GSEs, and, finally, provide GAO's views on whether REFCORP, if established and operated as currently described in draft legislation (H.R. 1278), should be treated in budget documents as an on-budget federal corporation or, as envisioned by the administration, as an off-budget GSE.

I should preface my remarks by saying that in recent testimony on the savings and loan problem, we have said that any use of federal money to resolve the problem should be on-budget, even if that means changing the Gramm-Rudman-Hollings deficit targets.

OVERVIEW OF GSEs

GSEs are chartered by the federal government pursuant to legislation, and they traditionally have been privately owned. Most current GSEs were established to buy and sell blocks of financial assets, primarily loan securities, to increase credit availability to certain target groups--such as home buyers, farmers, and students. Operating with various forms of federal backing, these GSEs are able to operate with relatively low money costs.

There are 10 GSEs currently operating. Attachment I lists them along with some pertinent details on each one. They range from the large Federal Home Loan Banks, with gross disbursements of about $189 billion in fiscal year 1988, to the smaller Federal Home Loan Mortgage Corporation ("Freddie Mac") with disbursements of about $6 billion. These GSEs disbursed about $326 billion in 1988, equivalent to about one-fourth the amount disbursed by the government.

Most GSEs finance their activities in part by selling securities to the public, just as the U.S. Treasury sells most of its securities to the public to finance the activities of federal agencies. In fiscal year 1988, GSEs borrowed about $95 billion from the public, which compares with similar Treasury borrowings that year of about $162 billion. One year earlier, in 1987, GSEs borrowed $125 billion. Such large GSE borrowings can compete with Treasury issuances in the securities market, and potentially affect interest rates paid by the Treasury and other borrowers. For this reason, GSEs by law or custom normally consult with the Treasury on their planned borrowings.

The GSEs reflect a variety of organizational and financing approaches. However, there are three features common to most GSEs that I would like to discuss.

Private Financing

GSEs normally obtain their funds from the private sector rather than the U.S. Treasury. They raise funds through a variety of means, including selling stock, securities, and financial assets in the private sector, and by collecting premiums and fees for services rendered. Most do not receive appropriations. This private side to GSE transactions is reflected in the fact that GSEs are not subject to Office of Management and Budget (OMB) apportionments, most GSE debt is not explicitly guaranteed by the U.S. government, and GSE receipts and outlays are not included in the U.S. government's budget totals. I will return to this last point later in my statement.

Mixed Control

Typically, most board members of a GSE are private persons selected by the GSE's shareholders or other nonfederal entities. Similarly, the employees are generally not part of the federal civil service and are not subject to federal pay limitations.

However, there is a degree of federal control. All GSEs are authorized in federal legislation, chartered by the U.S. government or one of its agencies, and their activities are limited by the terms of the charter. Most GSE charters provide that a federal official, sometimes the President, shall appoint a certain number (normally a minority) of the GSE board's members. That federal official also may be authorized to appoint the board's chairman. Some, such as the Federal Home Loan Banks, are explicitly mentioned in law as subject to audits by GAO.

Governmental Benefits

Federal legislation confers a number of benefits on GSEs not provided most private companies. Most GSEs are given a line-of-credit with the Treasury (which most have not used), and their investors' interest income is exempted from state and local taxation. Although they sell securities, most are exempted from Securities and Exchange Commission (SEC) registration requirements. As a result of these benefits and their ties to the U.S. government, GSEs are perceived to be instruments of federal policy enjoying an implicit federal guarantee of their liabilities. This allows them to borrow at rates only slightly above Treasury's cost of money.

THE BUDGET TREATMENT OF GSEs

OMB and Congressional Budget Office (CBO) budget documents show three kinds of totals: on-budget governmental, off-budget governmental, and governmentwide. The on-budget category includes the receipts and outlays of most governmental programs. The off-budget category includes the amounts of the two Social Security trust funds. By law, the Social Security amounts are excluded from the budget's totals. However, they are not excluded from the deficit calculation under Gramm-Rudman-Hollings. Both organizations also combine the on-budget and off-budget totals into a governmentwide total for purposes of fully disclosing the government's fiscal activities.

GSEs are not included in any of these totals. Their activities are not reported as part of the U.S. government's surplus or deficit, and are not covered by the Gramm-Rudman-Hollings deficit reduction legislation. Both OMB and CBO state that excluding GSEs from the government's totals generally follows a recommendation of the 1967 President's Commission on Budget Concepts, which held that government-sponsored enterprises that are "completely privately owned" should be excluded.

OMB's budget documents, however, contain special sections in which the activities and amounts of the GSEs are reported for information purposes. This, too, is in line with a recommendation of the 1967 Commission.

IMPLICATION FOR REFCORP

Mr. Chairman, you asked us to address whether REFCORP, if given the features described in the administration's proposal, should be considered a GSE, warranting off-budget status, or a federal agency, which would normally imply on-budget status. I should preface my remarks by stating that our conclusions could change if there are significant changes to H.R. 1278, entitled "The Financial Institutions Reform, Recovery and Enforcement Act

of 1989." But first, let me outline in general terms how REFCORP would operate and describe the budgetary implications of treating REFCORP as an off-budget GSE instead of an on-budget federal corporation.

How REFCORP Would Operate

REFCORP would be established as an off-budget GSE to raise funds for a new on-budget federal corporation created by the same legislation, the Resolution Trust Corporation (RTC). The latter would be responsible for resolving currently insolvent savings and loan institutions and those which become insolvent during the 3 years after enactment of the legislation. The RTC would use funds provided by REFCORP.

REFCORP would fund the RTC by borrowing $50 billion in the securities market, through sales of 30-year REFCORP bonds, and then transferring the borrowed money to RTC by purchasing (using the borrowed funds) capital certificates of the RTC. The legislation would require savings and loan industry sources to provide about $5 billion to $6 billion to REFCORP by purchasing REFCORP nonvoting common stock. REFCORP would use this money to purchase 30-year, zero coupon Treasury bonds. Upon maturity, these bonds would provide REFCORP the $50 billion needed to pay off its debt principal.

Under the plan, no U.S. Treasury dollars would be needed to pay off the principal. Indeed, the legislation would stipulate that there is no federal government guarantee of REFCORP's repayment of this $50 billion. However, there would be a statutory requirement for the federal government to pay that portion of REFCORP's interest payments (on the $50 billion in borrowings) not covered by the proceeds from liquidating the assets of failed savings and loan institutions and from other industry amounts available to REFCORP.

Budgetary Implications of
Treating REFCORP as a GSE

Let me now turn to the budgetary implications of treating REFCORP as a GSE. The existing provisions of H.R. 1278 do not stipulate that REFCORP's receipts and outlays would be excluded from the government's totals. However, the administration's explanations of the proposal clearly indicate that OMB would treat REFCORP like other GSEs and exclude its amounts from the government's totals. The theory is that REFCORP is essentially privately owned.

The budget advantage of classifying REFCORP as an off-budget GSE, and having it rather than the Treasury borrow the funds needed for savings and loan case resolutions, is that such an approach would minimize the short-term impact of resolution actions on the government's reported deficit. This, of course, would make it much easier for the government to meet or approach its Gramm-Rudman-Hollings deficit targets over the next few years.

Classifying REFCORP as an off-budget GSE would minimize the short-term deficit impact because REFCORP's $50 billion payment to the RTC would then be treated as private GSE money flowing from outside the government to a federal corporation. In other words, the money the government receives from REFCORP would be treated as a federal collection rather than a federal borrowing. Under established budgetary conventions, collections are offsets that reduce (by the amount of the collections) the budget's reported net outlays. On the other hand, amounts borrowed by the government are not counted as offsetting collections, and for good reason--to do so would permit the government to balance its books through borrowings.

We and others have pointed out that this off-budget REFCORP approach would have the longer-term consequence of increasing Treasury's interest costs over those that Treasury would pay if it, rather than REFCORP, borrowed the funds and made them available for resolution actions. This is because REFCORP's borrowings would carry higher interest costs than Treasury's. According to the administration, REFCORP would have to pay 25 basis points more than Treasury would have to on 30-year bonds, adding $3.8 billion to Treasury's interest costs over the life of the program. There are other estimates of higher added interest costs.

Partly out of concern over such added interest costs, some parties have advanced proposals or options that would fund the government's resolution actions through Treasury rather than REFCORP borrowings. I should add, though, that such an on-budget Treasury-financed approach would increase the budget's reported deficit, because the government's large resolution outlays would not be offset by collections from a GSE. Administration officials have stated that this would cause concern in domestic and international financial circles. Others, however, have testified that the financial markets already are recognizing the fiscal implications of the current problem and would not be adversely affected by an on-budget approach.

Also, some point out that an on-budget approach would increase reported outlays beyond fiscal year 1989, for any resolution actions that could not be completed in 1989, and add to the difficulties of reaching the Gramm-Rudman-Hollings deficit targets. Actions would be needed to either raise the Gramm-Rudman-Hollings deficit targets, or exempt the resolution outlays from the calculation of the deficit. As I stated earlier, we have expressed the view that the targets should be raised to accommodate any extra governmental spending to resolve the savings and loan industry crisis.

Ultimately, the question of whether Treasury or REFCORP borrowings are used will be a policy choice of the Congress and the President. And I would suggest that in making that choice, our elected officials should consider carefully whether it makes sense to treat REFCORP as a GSE. We expect that in this period of tight budgets, pressures will mount for more off-budget, GSE approaches.

However, if budget discipline is to be maintained, care should be taken to avoid creating new (off-budget) GSEs that, in reality, are more like federal agencies performing governmental functions. The label "GSE" should not be loosely given to justify off-budget approaches and make it appear that the government is staying within deficit targets.

Should REFCORP be Considered a GSE?

In our view, this question should be approached by looking at the ownership of REFCORP, and the substance of its transactions.

On the ownership matter, we would want to know who exercises control over the entity and who bears the financial responsibility for any losses. In the case of governmental agencies, the U.S. government directs and staffs the operations and generally is responsible for their incurred liabilities and losses. In the case of most GSEs, the direction of the entities is mixed but essentially private, with the boards of directors (most of whom are private sector persons) having considerable latitude to make decisions within the broad outlines of the GSE's charters. The legal liability for losses resides with the GSEs and their shareholders rather than the federal government. The

Federal National Mortgage Associations ("Fannie Mae") is such a GSE.

Concerning the substance of the transactions, a judgment should be made about the purpose and function of the entity. Do its transactions directly benefit the federal government, with persons outside of the government benefitting indirectly (albeit perhaps in a significant way), or do its transactions directly benefit groups outside of the government? Looking at the substance of an entity's transaction can be particularly helpful in cases where it is not clear who controls the entity or bears the ultimate financial responsibility.

Let us now apply these standards to the proposed REFCORP. First, what about REFCORP's ownership? There are, indeed, certain private features. REFCORP's three board members would come from a GSE--two presidents of Federal Home Loan Banks, and the director of the Banks' Office of Finance. Also, REFCORP would rely upon employees of the Federal Home Loan Banks for its staff support. REFCORP would have no staff of its own.

Furthermore, the capitalization of REFCORP would come from the nonvoting common stock purchases of the private Federal Home Loan Banks. REFCORP would pay off the principal on its 30-year debt using the proceeds of zero coupon bonds it purchased using industry funds, and there would be no federal guarantee of REFCORP's debt principal.

There also are governmental features. The federal government would probably exercise closer control over REFCORP than it does over most other GSEs. The authorizing legislation would narrowly circumscribe the permissible activities of REFCORP, and provide for close supervision of REFCORP by the RTC's Oversight Board. As we stated earlier, RTC would be established as a federal corporation. The proposed law states that REFCORP, ". . . shall be subject to such regulations, orders, and directions as the Oversight Board may prescribe." According to the draft legislation, the Oversight Board would make the decisions on the amounts, timing, and methods of REFCORP's financing, including the amount of REFCORP stock that the private Federal Home Loan Banks would have to purchase.

Finally, the federal government would assume a legal liability for part or all of REFCORP's interest costs. To the extent that REFCORP's interest costs are not covered by designated REFCORP income (asset liquidations and Federal Home Loan Bank funds), Treasury must make up the shortfall. Administration officials estimate that this would cost the Treasury about $89 billion in interest outlays over the life of REFCORP's 30-year bonds.

When we consider on balance the various features of REFCORP, we are led to believe that REFCORP would more closely resemble a federal agency than a GSE.

This view is reinforced by the substance of REFCORP's transactions. REFCORP's relationship to the public would have a distinct governmental feature in its sole purpose and function--to borrow funds from the public and disburse those funds to a federal corporation, the RTC, for use in liquidating obligations of the federal government. Also, the funds REFCORP would receive from the savings and loan industry (to buy the zero coupons) would resemble tax revenues in their involuntary nature. The Federal Home Loan Banks would have little choice but to purchase REFCORP's stock, and the insured savings and loan institutions would have to pay their "assessments." We should add that these industry sources of REFCORP funds would have little or no expectation of ever getting their funds back: REFCORP is not designed to be a profit-making entity.

CONCLUDING REMARKS

In conclusion, Mr. Chairman, we believe that if REFCORP is used as part of the solution to the savings and loan crisis, it should be on-budget as a federal corporation. We have reached this conclusion after considering the ownership of REFCORP and the substance of its transactions. It is especially clear to us that the substance of REFCORP's activities is governmental--it is designed solely to raise funds for a federal corporation to satisfy federal obligations to the American public, and it relies upon tax-like collections from industry sources.

We are concerned about the growing number of proposals to establish off-budget entities to carry out governmental functions. These proposals, whose apparent purpose is usually to avoid the discipline required by constrained budget resources, are a serious threat to the integrity of the government's budget and financial management systems. If the proliferation of such entities continues, it will raise grave doubts about the credibility of the government's reports on its financial operations and condition, making it even more difficult for decisionmakers and the public to understand and deal meaningfully with the overriding problem of the budget deficit.

Thank you, Mr. Chairman. This concludes my prepared statement, and I would be glad to answer any questions you or members of the Committee may have.

ATTACHMENT I

ATTACHMENT I

GOVERNMENT-SPONSORED ENTERPRISES

Government-Sponsored Enterprise	Year Established	FY 1988 Borrowings (billions)	FY 1988 Disbursements (billions)
Financing Corporation	1987	$ 3.2	$ 0.0
Federal Home Loan Banks	1932	21.6	188.7
Federal Home Loan Mortgage Corp.	1970	15.4	5.5
Federal National Mortgage Assoc.	1938	50.0	35.0
Student Loan Marketing Assoc.	1972	3.7	10.1
College Construction Loan Insurance Assoc.	1986	0.0	0.0
Banks for Cooperatives	1933	2.3	67.3
Farm Credit Banks	1988	(2.2)	19.2
Farm Credit System Financial Assistance Corp.	1988	0.5	0.4
Federal Agricultural Mortgage Corp.	1988	0.0	0.0
Subtotal		94.5	326.2
Less: Borrowings from other GSEs		(0.4)	
Total		$ 94.1	$ 326.2

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Chairman ROSTENKOWSKI. Mr. Bowsher, can you estimate the costs to the Federal Government of issuing RefCorp debt directly to the public, rather than Treasury borrowings through the Federal financing bank?

Mr. BOWSHER. We think the estimate of 25 basis points and somewhere around $4 billion is probably as close an estimate as we can give, and what I believe is being held up by the other people too.

Chairman ROSTENKOWSKI. Treasury has argued that the $50 billion of principal repayment on RefCorp bonds should be treated as off-budget, because the principal is paid by contributions from private industry. How do you evaluate this argument, Mr. Bowsher?

Mr. BOWSHER. Well, we think that that is one of the factors to consider—where the principal is coming from—but when you look at the interest costs and look at the fact that the Treasury probably is going to have to pay a good portion of that, and it is going to be such a sizable figure, then we do not think that the capital item is the controlling one. We think that the interest cost is probably a more persuasive case for keeping it on-budget, and not treating it in an off-budget manner.

Chairman ROSTENKOWSKI. Mr. Downey.

Mr. DOWNEY. Mr. Chairman, in terms of the assessments of RefCorp, I mean is it reasonable to assume that the payments by the Treasury and not the assessments would finance about 90 percent of RefCorp's debt?

Mr. WOLF. If you look at the principal, and you assume that the interest to defease those is coming from Treasury, then also a significant portion of the principal is, in fact, coming from Treasury interest payments.

Mr. DOWNEY. Is it not something of a fiction to think that the putting of RefCorp off-budget and the use of zero coupons in the financing mechanism is really a method of getting the guilty parties, or the industry—I should not say guilty parties in this instance—the industry to pay the debt? I mean, are not the taxpayers really holding the bag for a lot of the problems of the S&L's?

Mr. BOWSHER. I think the main motivation was to get it off-budget, and I think the second motivation was to try to get the industry to make some contribution, and they are doing that by bringing in literally these funds as the capital contribution.

But as you point out, Mr. Downey, it probably is a small percent of the total number over all these years that this is going to be in being.

Mr. DOWNEY. I mean, is it conceivable that in our desire to have the S&L's pay something, the taxpayers will pay more? I mean——

Mr. BOWSHER. Well, yes. I think that is very conceivable, you know.

Mr. DOWNEY. So, it kind of puts us in an interesting position——

Mr. BOWSHER. And I also think you could have got the industry to have made a contribution to an on-budget solution. In other words, I do not think one excludes the other.

Mr. DOWNEY. Thank you, Mr. Bowsher.

Mr. Chairman, I would hope that—I mean, I am just going to obviously speak for myself here—that this entire process of financing, while it makes sense to the administration, to me it is just an in-

teresting way of putting the debt on somebody else; namely, our children or our grandchildren. I would hope that we would, to the extent that we have any jurisdiction over this matter, weigh in heavily.

Mr. STARK. Will the gentleman yield?

Mr. DOWNEY. I would be happy to yield to Mr. Stark.

Mr. STARK. Mr. Bowsher, if we took, under this same reasoning—if the total debt of the country is around $3 trillion——

Mr. BOWSHER. That is right. Close to $2.9 trillion.

Mr. STARK. If we just took and sold $300 billion of zero coupons, say to the Japanese today, saying 30 years from now they would come back as $3 trillion, we could do away with the whole national debt by this same sort of reasoning. [Laughter.]

Could we not? I mean, if it is good for $5 billion, why not up the ante a little, and let us get rid of the whole deficit?

Mr. BOWSHER. Well, you know, about 2 weeks ago I was speaking to the——

Mr. STARK. Well, you have already suggested that. [Laughter.]

Mr. BOWSHER [continuing]. League of Cities, and Congressman Panetta was with me, and the first question we got was, we had to give up our revenue share, and we had to give up a lot here in the last few years, and we were always told that it was because the Federal budget was very tight—the deficit was very large.

Then, when you get into this situation, all of a sudden we find that we can have a new corporation off-budget, and they were wondering how soon that we could devise an off-budget corporation for them. So it is a similar issue, and yes, that is right, you are just going to have a bigger one.

Mr. STARK [continuing]. The alternative of getting an S&L.

Mr. BOWSHER. Yes.

Chairman ROSTENKOWSKI. Mr. Gradison.

Mr. GRADISON. Thank you, Mr. Chairman.

Mr. Downey, very properly, is concerned about the next generation. I think we also should be concerned about those in this generation that are paying part of this bill and trying to keep the bill as small as possible. That is the part that disturbs me.

I frankly have a very difficult time going back to my area, where the savings and loans are not in trouble, and explaining to them why they have to pay a higher assessment, and meet new and higher capital standards. The people outside of the industry—that is, the general taxpayers—are also going to be paying more over the years in interest than if we had financed this in another way.

The easy way is just to vote against this in the end, but I think if there is anyway we can help to prevent this travesty, it is worth the effort.

I would like to direct just a couple of quick questions to Mr. Bowsher. First of all, in your judgment, is this financing plan adequate to cover the problem of the savings and loan industry?

Mr. BOWSHER. We are not sure, Mr. Gradison. In other words, we have said all along there are three or four issues that worry us. One is the interest rate assumptions. Two is the assumptions on the growth of the deposits.

In other words, in the plan you have a growth rate, I believe, of about 7 percent, and what you really have is a decline in recent

weeks and months here on the amount of deposits, and of course, the economic assumptions.

If the economy does not perform as strong as the economic assumptions that are in the budget, why that could also be a factor, and we worry a little bit about how the play-out of this whole liquidation and a merger arrangement, because we are taking on a bailout here that is far larger than anything we have ever done in recent times. So I think you have got four issues there that could change the total cost of this program quite a bit.

Mr. GRADISON. Does the General Accounting Office audit any of the GSE's?

[Pause.]

Mr. BOWSHER. We should know that.

Mr. WOLF. Let me check. I do not think we——

Mr. GRADISON. While you are looking that up, let me ask you another question. Would you, under the proposal of the administration, have the authority to audit this new GSE?

Mr. BOWSHER. Yes, we would.

Mr. GRADISON. You would audit RefCorp——

Mr. BOWSHER. Yes.

Mr. GRADISON [continuing]. And the Resolution——

Mr. BOWSHER. And the RTC? No, but we have proposed a GAO audit requirement for RTC.

Mr. WOLF. And we review the CPA audit of FICO currently. That is the only one on the list——

Mr. BOWSHER. We do not audit the big ones. They have independent CPA audits.

Mr. WOLF. I believe, from looking at the list, all of them have a CPA audit. Some of those audits we review on a periodic basis.

Mr. GRADISON. Could you submit that for the record? It seems that you have some and not others. It would be helpful to have that for the record.

Mr. BOWSHER. Yes, we will put that in the record.

Mr. GRADISON. Thanks a lot. Thank you, Mr. Chairman.

[The following was subsequently received:]

INSERT "A"

Government-Sponsored Enterprise	GAO Audit Authority	Audit/ Review
Financing Corporation	The Comptroller General has authority to audit financial transactions during periods in which capital of the United States Government is invested in the Corporation. 31 U.S.C. section 9105 (a) (1) (B).	CPA hired by Federal Home Bank Board. GAO reviewed the CPA audi of the 1987 financial statements.
Federal Home Loan Banks	Audits of the financial transactions of a Federal Home Loan Bank are not limited to periods during which government capital is invested in such banks. 12 U.S.C. section 1431 (j). The banks must be audited on a calendar year basis. 31 U.S.C. section 9105 (a) (2).	CPA hired by Federal Home Bank Board. GAO reviewed the CPA audit of the 1987 financial statements.
Federal Home Loan Mortgage Corporation	Financial transactions of the corporation are subject to audit by GAO. 12 U.S.C. section 1456 (b).	CPA audits. GAO reviewed the CPA audit of the 1987 financial statements and is now reviewing the audit of the 1988 statements.
Federal National Mortgage Association	No express GAO audit authority. The Department of Housing and Urban Development may audit under 12 U.S.C. section 1723a (h)	GAO performed a review of the role of the Federal National Mortgage Association in the REMIL market in 1988.
Farm Credit Banks	The Farm Credit Banks are composed of the Federal Intermediate Banks and the Federal Land Banks.	GAO performed programmatic

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Government-Sponsored Enterprise	GAO Audit Authority	Audit/ Review
	Although the two banks were merged into a single system of Farm Credit Banks by the Agricultural Credit Act of 1987 which did not specifically provide for audit authority of the new entity, the audit authority which applied to the merged banks continues to apply to the new entity. Audit authority over the merged banks was limited to periods in which government capital was invested in these entities. 31 U.S.C. section 9105 (a) (1) (B). Additionally, the Comptroller General was authorized to examine all books, documents, papers, records or other recorded information of these entities. 12 U.S.C. section 2276.	reviews of Farm Credit System financial condition and management in 1985, 1986, 1987, 1988, and 1989.
Bank for Cooperatives	Audit authority is limited to periods in which government capital is invested in these entities. 31 U.S.C. section 9105 (a) (1) (B). Additionally, the Comptroller General is authorized to examine all books, documents, papers, records or other recorded information of these entities. 12 U.S.C. section 2276.	GAO performed programmatic reviews of Farm Credit System financial condition and management in 1985, 1986, 1987, 1988, and 1989.
Federal Agricultural Mortgage Corporation	The Comptroller General has authority to perform financial audits of this corporation on whatever basis the Comptroller General determines to be necessary. 31 U.S.C. section 9105 (a) (4). The Comptroller General of the United States shall annually review, and submit to the Congress a report regarding, the actuarial soundness and reasonableness of the fees established by the Corporation under this subsection. P.L. 100-233, 101 STAT. 1701 section 8.10 (b) (4). The Comptroller General of the United States shall conduct studies	New entity, no GAO financial audit. However, GAO has studied and issued reports on various issues related to the Federal agriculture market.

INSERT "A"

Government-Sponsored Enterprise	GAO Audit Authority	Audit/ Review
	of the implementation of the amendments made by this title by the Federal Agricultural Mortgage Corporation and the effect of the operations of the Corporation on producers, the Farm Credit System, and other lenders, and the capital markets; the feasibility and appropriateness of promoting the establishment of a secondary market for securities representing interests in, or obligations backed by, pools of agricultural real estate loans for which a guarantee has not been provided by the Federal Agricultural Mortgage Corporation; the feasibility of expanding the authority granted under the amendments made by this title to authorize the sale of securities based on or backed by a trust or pool consisting of loans made to farm-related and rural small businesses. For purposes of the preceding sentence, the term "farm-related businesses" means businesses 90 percent or more of the annual dollar volume of the sales of which are made to agricultural producers. P. L. 100-233, 101 STAT. 1706 section 704 (a) (1) (2) (3). Not later than 2 years after the date of enactment of this Act, the Comptroller General of the United States shall transmit to the Congress a report on the studeies required by subsection (a), including therein such recommendations for administrative action and legislation as may be appropriate. P. L. 100-233, 101 STAT. 1706 section 704 (b).	
Farm Credit System Financial Assistance Corporation	No express audit provisions. The corporation has informed us that it contracts for an audit by the Price-Waterhouse firm.	
Student Loan Marketing Association	No express GAO audit authority. 20 U.S.C. sections 1087-2 (j),(k) require an annual audit by independent public accountants, with reports to Treasury, the President and	GAO is studying various issues relating

INSERT "A"

Government-Sponsored Enterprise	GAO Audit Authority	Audit/ Review
	Congress. The Comptroller General and the Inspector General of the Department of Education shall each have the authority to conduct an audit of the financial transactions of any guaranty agency operating under an agreement with the Secretary pursuant to section 428 (b); any eligible lender as defined in section 435 (d) (1) (D), (F), of (H); a representative sample of eligible lenders under this part, upon the request of the Committee on Education and Labor of the House of Representatives or the Committee on Labor and Human Resources of the Senate, with respect to the payment of the special allowance under section 438 in order to evaluate the program authorized by this part; and any Authority required to file a plan for doing business under section 438 (d). P.L. 99-498 100 STAT. 1403 section 432 (f) (1) (A) (B) (C) (D). For the purpose of carrying out this subsection, the records of any entity described in subparagraph (A),(B),(C), or (D) of paragraph (1) shall be available to the Comptroller General. For the purpose of section 716 (c) of title 31, United States Code, such records shall be considered to be records to which the Comptroller General has access by law. P.L. 99-498 100 STAT. 1403 section 432 (f) (2).	to student loans.
College Construction Loan Insurance Association	No express GAO audit authority. 20 U.S.C. section 1132f-9 requires an audit by independent public accountants, with reports to the President and Congress.	

Chairman ROSTENKOWSKI. Mr. Pickle.

Mr. PICKLE. Mr. Bowsher, what figure did you say that these GSE's—what are the obligations to our Government now? Did you say $700 to $800 billion?

Mr. BOWSHER. I think Congressman McGrath over here stated that figure, and I believe that is right. I believe it is in the CBO statement, but I believe it is about—it is over $700 billion.

Mr. PICKLE. Well, if we take—and this would be another $40 to $50 billion in addition to that?

Mr. BOWSHER. That is right, yes.

Mr. PICKLE. Now, we are faced with the problem that if we put it off-budget, we will payout a considerable amount of interest, will we not?

Mr. BOWSHER. You would be paying an additional interest cost. That is right.

Mr. PICKLE. And how much on an annual basis would you——

Mr. BOWSHER. Well, on an annual basis, I think it is estimated at about $4.5 billion——

Mr. PICKLE. Billion.

Mr. BOWSHER [continuing]. In 10 years.

Mr. PICKLE. Yes. All right.

Mr. BOWSHER. Ten years.

Mr. PICKLE. Now, if we put it on-budget as you recommend, that means then we would have to change the Gramm-Rudman-Hollings Act, would we not?

Mr. BOWSHER. That is correct. You would have to change the target figures.

Mr. PICKLE. You would have to change the targets, and the administration says they do not want to change the targets of Gramm-Rudman.

Mr. BOWSHER. That is correct. Anything that was done in 1989 would not have to change the target, but anything that would affect the other years would have to.

Mr. PICKLE. Well, the Gramm-Rudman is on the books for another 2 or 3 years, is it not?

Mr. BOWSHER. Through 1993.

Mr. PICKLE. If we put this off-budget, that will go on for what? Thirty years?

Mr. BOWSHER. Some features of it will go 30 years. That is correct.

Mr. PICKLE. Then, the gentleman may be correct that it would be better for the Government just to pay for this some way or another. If it is a Federal debt, put it on budget.

The question is, how can we do that? And the difficulty, I would say is that, who is going to offer such an amendment? Or at least if we offered it, would the administration approve it? And they said, "I assume that they would not." There would have to be a tax, would there not?

Mr. BOWSHER. I think the administration is taking a very strong position that they would not want it to be on-budget, that they want to go with this off-budget arrangement, and they are basing it on the reasoning that they do not want to change the Gramm-Rudman targets.

Mr. PICKLE. And that is basically the only reason, is it not?

Mr. BOWSHER. Yes.

Mr. PICKLE. Well, I thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. McGrath.

Mr. MCGRATH. Thank you, Mr. Chairman. It seems to me that the mechanism that we face here with the bill that is in front end runs this committee's jurisdiction we do have jurisdiction in other methods of financing that may or may not be on-budget.

I am not sure if we are going to even see that bill referred to us. Am I correct in that assumption?

Chairman ROSTENKOWSKI. We expect a report. We expect to be referred to. We do not guarantee that that will happen, but we do expect it to be sequentially referred.

Mr. DOWNEY. While the establishment of RefCorp and the RTC fall exclusively within the jurisdiction of the Banking Committee, we would be the committee that would vest RefCorp with the ability to do the off-budget financing. How does it work? Do you know off hand, Mr. Chairman?

Chairman ROSTENKOWSKI. Well, I believe we have jurisdiction over debt management, and although, I think, the Banking Committee could create RefCorp and the RTC, I think that the bill would be sequentially referred to us, for us to endorse.

Mr. DOWNEY. Would we be in the position of offering amendments that I assume at this point, from what I have heard from my colleagues on the other side, could fashion a change so that, as Mr. Pickle has pointed out, if we wanted to currently finance some of this as opposed to establishing RefCorp, that we would be in a position to amend legislation to that effect?

Chairman ROSTENKOWSKI. Yes.

Mr. MCGRATH. Well, reclaiming my time, I have a feeling, though, out there in some other committee, that they are trying to fashion this thing, so that you could do an end run on us, knowing our opposition to the present method of financing.

However, let me ask this question. You answered Congressman Gradison by saying that you do have——

Chairman ROSTENKOWSKI. If the gentleman will yield?

Mr. MCGRATH. Certainly.

Chairman ROSTENKOWSKI. There are tax features in RefCorp that will certainly come to this committee. Now, whether or not it is limited to that, the Chair is in doubt, but when the bill comes to the committee with those tax provisions, I am sure that we will be able to discuss them here.

Mr. MCGRATH. Well, I thank the chairman for his answer on that.

You have responded to Bill Gradison's question about your mandate to audit any of these GSE's, and I guess in RefCorp, you do have some mandate to do that, and others you may or may not.

I am just wondering whether or not there are other GSE activities open to the same kind of fraudulent business practices that we have witnessed in the S&L, and if so, what is our liability here?

Mr. BOWSHER. I am not sure whether they are or not, but you can obviously see by the total that the potential liability, if there was any of them to get into trouble, could be very large.

We faced it a few years ago in the farm credit system, and so one of the things we are doing is we are doing a study of the GSE's

right now, and we would hope to have that report to the Congress here in the next few months. And I also believe the Congressional Budget Office is doing a study. These two studies might be helpful.

Mr. McGRATH. Absent any fraudulent business activities that may cause us a problem as we have seen in perhaps the S&L's, what would be the effect of a very sharp rise in interest rates on our Government liability as a result of the activities of these GSE's?

Mr. BOWSHER. Well, it could make things difficult for some of them. As it has in the past, they have been able to work themselves through it, except for the farm credit, and so any run up in the interest rates on any of these institutions generally has an effect that makes life more difficult, and so that would be one of the things we are looking at in the review.

Mr. McGRATH. My understanding is that of the universe of borrowing in this country today, the borrowing by GSE's represents about 50 percent of the borrowing, and it seems to me that it is creating or it could be creating a crowding out of the market share here and institutionalizing higher interest rates.

Mr. BOWSHER. Yes. That has been a debatable issue among the people who have studied about the crowding out, but there is no question that the size of the borrowings has become very large and is large in relationship to the total Treasury borrowings.

In other words, your total Treasury borrowings is something over $2 trillion to the public, and this one is getting up around $700 billion, and we are adding $50 billion as somebody says here. So we are up around $800 billion probably here. So there is no question, and a lot of the same people, same institutions and even overseas, who are looking forward to buying Treasury securities are also being asked to buy these agencies' securities.

Mr. McGRATH. Well, it seems to me that we have got a little bull by the horns here, and I will be interested in seeing what you and the Congressional Budget Office might report because to be honest with you, I had no idea or little idea that the amount of the borrowing was the extent that it is.

Thank you, Mr. Chairman.

Mr. PICKLE. Will the gentleman yield?

Chairman ROSTENKOWSKI. The gentleman's time is up. Mr. Moody?

Mr. MOODY. Thank you, Mr. Chairman. I would like to—I will yield to you, Mr. Pickle.

Mr. PICKLE. Thank you. I want to make this statement to Mr. Bowsher and to the chairman of our committee. I am concerned that I do not know the status of many of these off-budget agencies, such as Fannie Mae and Sallie Mae

It is a proper and legitimate question that has been raised for our Government and for the American people. I want to know what is happening there.

Now, I hear you say that there is a study on the way, and you are making an evaluation, and the Treasury representative said the same thing, but you indicated that it is going to be 3 or 4 months before that study may be known to us.

Now, it is very likely that the Banking and Currency Committee, and another committee are going to pass this savings and loan bill,

and it will be referred to our committee, and I am told that we may get as much as a week to consider it.

That means that we will be acting before we get any response. So I would say, Mr. Chairman, we ought to make a specific request of this administration to give us a preliminary summary analysis of the status, particularly the solvency of all of these agencies, because the implicit faith of the Government is behind every one of those off-budget matters. If we create another one before we have any analysis of this issue, it seems to me like we are rushing out a little fast.

I would like to get that report, and I would like the chairman to inquire of the Government if we can get some of this analysis or evaluation immediately, and not wait for the fall to get it, after we have already acted.

I thank you, gentlemen.

Mr. MOODY. Thank you. Mr. Bowsher, you know the rationale around here for focusing on the deficit and doing something about it through Gramm-Rudman is not really to meet some accounting nicety or some requirement of balancing the budget. We have not balanced the budget for many years in a row.

It is the size of the deficit that has become a concern, not in an accounting sense, but in an economic sense. The demand that the deficit places on national savings diverts savings away from productive investment in the private sector. It now directly drives foreign borrowing, which puts us deeper and deeper in hock to our foreign trading partners, with fallout on our trading balance.

That is the real concern. Now, does it make any sense in that context to turn to an accounting solution to the problem by moving it off budget—so that it does not look as bad——

Mr. BOWSHER. No.

Mr. MOODY [continuing]. When, in fact, the demand on savings, and the demand for foreign borrowing has been driven just as much as if it were on budget.

My second question is, Is the market going to be fooled by this accounting artifice? Or is the market going to know what we are really doing? Would they treat it more honestly if we said, "OK, look. We have got a problem."

We are going to have to amend Gramm-Rudman for this special occasion, or we are going to have to do something else—God forbid—like raise taxes to cover our costs, rather than pull off these accounting tricks. Would you comment?

Mr. BOWSHER. I think that we would be much better off to put it on the budget, in the accounting records at the end of the year, and to be very straightforward, and I have felt this all along.

I feel one of the unfortunate side-effects of the Gramm-Rudman process is that it is pushing us more and more to this blue smoke and mirrors, and to budgeting and bookkeeping techniques that are fooling no one.

In other words, I think that the markets and the people in the markets, not only in New York, but in London and Tokyo and around the world, are understanding very well that what we are doing is pushing off some of the dollars and some of the size of our deficit into entities that are being created for that purpose, and I think it makes no sense at all myself.

Mr. MOODY. So we have lost sight of the real purpose of Gramm-Rudman.

Mr. BOWSHER. If you remember then, the real purpose of Gramm-Rudman—I think Senator Rudman used to describe it best. He said, "It was not the greatest process in the world, but its time had come to force big, tough decisions on reducing the budget deficit."

Mr. MOODY. Right.

Mr. BOWSHER. Unfortunately, except for the first sequester, why, it has not forced those big, tough decisions. It has really kind of forced people to figure out how to make the targets by whatever they had to do to make it. They have moved payrolls from one fiscal year to another.

Mr. MOODY. They move them forward.

Mr. BOWSHER. They are now moving the agriculture payments into 1989. So it has become a series of gimmicks, really, to make the targets, and I do not think we are fooling anybody. In fact, I think even the press now, if you looked at the programs on the weekend—all of the press questioning was saying, "Come on, quit fooling us. Quit trying to fool us."

Mr. MOODY. I for one would hate to see this committee put its stamp of approval on what is basically a sham operation, and pretending this is not a demand on savings just as like if it were on Gramm-Rudman.

Mr. BOWSHER. Well, I agree with that.

Chairman ROSTENKOWSKI. Thank you very much, Mr. Bowsher. I guess we are all recognizing that the day of reckoning is soon going to be upon us, and we are not ——

Mr. BOWSHER. Exactly right.

Chairman ROSTENKOWSKI [continuing]. Going to be able to inhale all of the smoke and color all of the mirrors blue pretty soon. We are all going to have to face up to what our responsibilities are.

Thank you very much for joining us.

Mr. BOWSHER. Thank you.

Chairman ROSTENKOWSKI. The committee will resume its sitting at 1:45.

[Whereupon, at 12:06 p.m., the committee recessed to reconvene at 1:45 p.m.]

AFTERNOON SESSION

Chairman ROSTENKOWSKI. The committee will come to order.

It is a privilege this afternoon to have with us a young man, in my opinion, who knows more about the budget office than most people that have served either as its director or in the staff. I am pleased, Bob, to have you join us this afternoon. I congratulate you. I do not know whether that is not the mother-in-law going over the cliff in the cadillac but we have a lot to do, and this committee, I think, is going to be working with you over the next 2 years.

There is no question in my mind that when the hard ball is played, and that is probably going to take place in about another 7 or 9 months, that we will be working with you, and I think the administration will be coming to the realization that there is going to have to be some hard decisions made.

Having that as a preface to your observations I would like you to know that I reflect the views of all of the members of the committee that we are pleased that you are now the Director of the Congressional Budget Office, and that I hope that we can show the mettle that is necessary to put this country back on a sound economic course.

Having said that, the committee is ready to take your testimony.

STATEMENT OF ROBERT D. REISCHAUER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE, ACCOMPANIED BY JAMES L. BLUM, ASSISTANT DIRECTOR, BUDGET ANALYSIS DIVISION

Mr. REISCHAUER. Thank you, Mr. Chairman.

The Congressional Budget Office [CBO] looks forward to working with you and this committee over the next few years, as we have in the past. With your permission, I will submit my complete statement for the record and summarize my answers to several of the questions that were asked in the invitation.

Chairman ROSTENKOWSKI. Without objection, your entire statement will be included in the record.

Mr. REISCHAUER. The first question was, "Does credit activity by Government-sponored enterprises [GSE's] pose a risk to the Federal Treasury?" The answer is "Yes." Government-sponsored enterprises are financial intermediaries chartered by the Government to give certain favored groups ready access to national capital markets. While GSE's are wholly owned by and operated for the benefit of private investors, they have been granted certain benefits that together strongly imply a Federal guarantee of their liabilities. This implicit guarantee suggests that the Government will assist them if they experience financial difficulties, as in the case of the farm credit system in early 1988.

This willingness to assist troubled GSE's means that most of the risks they assume are, in reality, borne by the Federal Government.

Second, the committee's letter asked what information is available to the Congress and the administration on the extent of the actual and contingent Federal liabilities created by GSE borrowing.

At present, the Government does not quantify the risks that GSE's pose. Three sources provide some information relating to the financial condition and activities of these enterprises. First, the special analyses volume of the Federal budget documents contains brief discussions of the legal benefits and activities of GSE's. Second, the appendix of the budget contains summary financial information and a projection of the aggregate borrowing and lending anticipated by each enterprise during the budget year. But these schedules are not reviewed or evaluated by OMB. They are simply printed as they are submitted.

Finally, each GSE issues an annual report that contains its balance sheets, income statements, and related data, all presented according to Generally Accepted Accounting Principles for private firms.

Taken together, all of this information is not sufficient to inform the Congress or the administration about the size of the risks being assumed by the Federal Government. For that purpose, one must

have an accurate measurement of the market value of each GSE's assets and liabilities as well as an analysis of uncertainty that surrounds each GSE's future economic performance.

Estimates of the market values of assets and liabilities have been made for only one GSE, the Federal National Mortgage Association [Fannie Mae], for the period from 1978 to 1986. This analysis showed that there were considerable gaps between the book and market values of Fannie Mae's net worth in some of the years that were examined.

A third question in the committee's letter asked whether GSE borrowing and guarantees, which in recent years amounted to about half of net Treasury borrowing during the year, might raise the interest rates on Treasury debt. The answer to this question is "No, or not by much." While borrowing by GSE's may initially push rates up slightly, subsequent relending of the proceeds should reduce rates by a roughly equivalent amount.

GSE activity may possibly enable farmers, savings and loans institutions, home buyers, students, or whoever benefits from them, to increase their borrowing more than other nonfavored borrowers reduce their borrowing. If so, interest rates on all debt would be higher than they otherwise would have been.

However, most analysts suggest that the increase in net borrowing caused by GSE's is very small, and, given that, it is unlikely that they would exert any significant upward pressure on Treasury borrowing rates.

Finally, let me say a few words about the Resolution Funding Corporation, or RefCorp, the last issue mentioned in the committee's letter of invitation.

RefCorp is a financing corporation that is authorized by the administration and that is an example of the administration's proposed reform of the savings and loan problem. It is an example of an off-budget borrowing corporation, an institutional form that first appeared in 1987 when the Government felt the need to use off-budget mechanisms to finance the liquidation of losses previously realized by the Government on deposit insurance and GSE activities.

The first of these borrowing corporations was FICO, the Financing Corporation, which was created to raise money to allow FSLIC to resolve insolvent thrifts. The second was FAC, the Financial Assistance Corporation, which was authorized to finance assistance to the ailing parts of the farm credit system.

In CBO's judgment, numerous arguments exist for considering borrowing corporations, such as RefCorp, to be parts of the Federal Government and for including their borrowing and spending in unified budget totals.

Using RefCorp as an example, this entity would be created by the Government for the sole purpose of financing spending by another Government agency, the Resolution Trust Corporation [RTC]. It would be controlled by Federal officials, the Oversight Board of the RTC. It would be nominally owned by the Federal Home Loan banks through their purchase of "nonvoting capital stock," but these payments, would be mandatory, and would, therefore, be more like taxes than equity investments on the parts of the owners.

RefCorp would also be authorized to collect assessments on federally insured savings and loans, which in our judgment is a governmental power. Furthermore, on a present-value basis, payments made by the Treasury would finance over 90 percent of RefCorp's debt.

Mr. Chairman, over the past few months there has been much discussion in Washington about applying the "duck" test to taxes. Maybe we should consider applying a similar test to the borrowing corporations. If they walk, talk, quack, and act like Government agencies, maybe they should be considered to be Government agencies, at least for budgetary purposes.

Reliance on RefCorp and other off-budget borrowing corporations has two clear disadvantages. First, it raises the costs of financing the liquidation of the Government's losses relative to the cost that would be incurred through direct Treasury borrowing. CBO has estimated that RefCorp would pay between 20 and 40 basis points more than Treasury borrowing on its debt. This difference would raise the cost of the interest payments on $50 billion in debt by an amount between $100 and $200 million a year, or, on a present value basis, by $1 to $2 billion over the 30-year term. Second, borrowing through off-budget corporations reduces the Treasury's control over debt issue to finance Federal spending.

The cost of using RefCorp for the resolution of insolvent thrifts could be reduced, as I have suggested, by having the Treasury borrow the money directly. This approach would also maintain the Treasury's control over Federal borrowing. Spending financed in this manner could be excluded from the baseline budget deficit calculations under the Balanced Budget Act, but we would not recommend that this apply also to the interest that the Treasury would pay on the borrowing.

An exclusion of this amount from the Balanced Budget Act totals could be justified by the fact that any increase in the Federal deficit that was used to finance the resolution of insolvent thrifts would have few of the adverse economic effects one ordinarily associates with increases in the Federal deficit.

Let me conclude by reiterating the two basic messages of my statement. First, while GSE's provide important types of Federal credit assistance, they expose the Government to considerable financial risks, the magnitude of which remains unmeasured and largely unknown.

Second, off-budget borrowing corporations such as RefCorp raise the cost of financing the liquidation of losses that have arisen from Federal guarantees. They do this with no discernible offsetting benefit to the taxpayer. If the Treasury were to borrow the needed funds directly, the cost could be reduced and the control of the Treasury over Federal borrowing could be increased.

Thank you.

[The statement of Robert D. Reischauer follows:]

STATEMENT OF ROBERT D. REISHCAUER
DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. Chairman, I am pleased to appear before the Committee this morning to discuss borrowing by government-sponsored enterprises (GSEs) and off-budget agencies, as well as the Resolution Funding Corporation (REFCORP), which is part of President Bush's proposal to address the savings and loan problem. In my remarks today, I will make three main points:

- First, while government-sponsored enterprises provide certain favored borrowers with the benefit of ready access to the capital markets, they do so at a cost of unrecognized and largely uncontrolled financial risks to the government.

- Second, the two off-budget borrowing corporations created in 1987 and 1988 and the proposed REFCORP differ significantly from government-sponsored enterprises in that their sole purpose is to finance the liquidation, outside the budget, of federal losses on GSEs and deposit insurance.

- Third, both types of entities impose costs on the federal government, but the nature of these costs and the means of limiting them differ. For GSEs, the key to federal cost control is to limit the risk assumed by the enterprises. For the new borrowing corporations, the key is to use the least costly means of financing available to the federal government.

GOVERNMENT-SPONSORED ENTERPRISES AS RISKY FINANCIAL INTERMEDIARIES

Before 1987, there were five GSEs--the member institutions of the Farm Credit System (FCS), the Federal Home Loan Banks (FHLBs), the Federal Home Loan Mortgage Corporation (Freddie Mac), the Federal National Mortgage Association (Fannie Mae), and the Student Loan Marketing Association (Sallie Mae). Table 1 provides information about these institutions. A sixth GSE--the Federal Agricultural Mortgage Corporation (Farmer Mac)--was created in 1988 but is not yet operating.

Government-sponsored enterprises have three outstanding characteristics:

- First, they are instrumentalities of the federal government, chartered for the purpose of borrowing in capital markets and channeling the money to favored borrowers--farmers, homebuyers, savings and loans, and students.

- Second, although they have public purposes, government-sponsored enterprises are wholly owned by and operated for the benefit of private investors.

- Third, their authority to borrow from the Treasury, the exemption of their securities from the registration requirements of the Securities and Exchange Commission, and other benefits they enjoy under federal law imply a government guarantee of their liabilities. This implicit guarantee

leads investors to accept yields on their debt that are quite close to the yields on Treasury securities. To illustrate this effect of government sponsorship, Table 2 compares the market yields on debt securities issued by several GSEs with the market yields on comparable Treasury debt, for a recent trading day. The spreads shown--between 30 and 50 basis points--are fairly typical and tend to be relatively stable over time.

In addition, the federal budget excludes lending and borrowing by GSEs. This exclusion follows the suggestion of the President's Commission on Budget Concepts, which recommended in 1967 that the government adopt a unified budget that would provide a comprehensive statement of all federal financial transactions. The Commission recommended that GSEs be excluded from the unified budget when they "are completely privately owned." This criterion has guided decisions about the budgetary treatment of GSEs since the unified budget was adopted in 1968.

TABLE 1. GOVERNMENT-SPONSORED ENTERPRISES

Enterprise	Established	Privatized	Assets[a]	Major Asset
Farm Credit System				
Farm Credit Banks	1988[b]	1988[b]	48.6	Farm loans and agricultural mortgages
Banks for Cooperatives	1933	1951	13.1	Loans to cooperatives
Federal Home Loan Banks	1932	1968	174.5	Savings and loan advances
Federal National Mortgage Association	1938	1970	112.3[c]	Residential mortgages
Federal Home Loan Mortgage Corporation	1970	1970	34.4[d]	Residential mortgages
Student Loan Marketing Association	1972	1982	28.6	Guaranteed student loans and "warehouse" loans

SOURCE: Congressional Budget Office.

a. Total assets at the end of 1988, in billions of dollars.

b. The Agricultural Credit Act of 1987 required the Federal Land Bank and the Federal Intermediate Credit Bank in each Farm Credit District to merge into a single Farm Credit Bank by July 6, 1988. The Land Banks had been established in 1916 and privatized in 1947; the Intermediate Credit Banks had been established in 1923 and privatized in 1968.

c. Amount does not include $178 billion in residential mortgages held in pools to back securities issued and guaranteed by the Federal National Mortgage Association.

d. Amount does not include $226 billion in residential mortgages held in pools to back securities issued and guaranteed by the Federal Home Loan Mortgage Corporation.

Risks Posed by Government-Sponsored Enterprises

The special legal benefits granted GSEs and the implicit federal guarantee of their liabilities indicate that the government will provide assistance to them if they get into serious financial trouble. The Agricultural Credit Act of 1987 provided such assistance to the Farm Credit System after it lost $4.6 billion in 1985 and 1986. The act set a second precedent by not requiring the owners of FCS member institutions to forfeit their equity investment as a condition of federal assistance.

The government's willingness to assist troubled GSEs means that it bears most, if not all, of the financial risks that they take. Although the government does not quantify these risks or the cost of bearing them, some general observations can be made about the risks posed by the five active GSEs.

Three GSEs--the FHLBs, Freddie Mac, and Sallie Mae--currently pose little risk to the government. The assets of the FHLBs consist largely of collateralized advances to savings and loans. Private mortgage insurance or low loan-to-value ratios minimize the risk of the residential mortgages that Freddie Mac holds in portfolio or has packaged and sold through mortgage-backed securities. Most of Sallie Mae's assets are federally guaranteed student loans. Changes in interest rates are unlikely to impose significant losses on these three GSEs. These enterprises also are well capitalized, given the risks they have assumed.

Fannie Mae and the Farm Credit System pose greater risk to the government. Both are exposed to some interest-rate risk. That is, everything else being equal, when interest rates increase, the marked-to-market net worth of each of these GSEs--the market value of its assets less the market value of its liabilities--declines measurably. Fannie Mae's capital-to-asset ratio, which is only 2.1 percent measured on a book-value basis, is low for a portfolio mortgage lender, even one with a large mortgage-backed securities business. The value

TABLE 2. SPREADS BETWEEN YIELDS ON GOVERNMENT-SPONSORED ENTERPRISE DEBT AND COMPARABLE U.S. TREASURY DEBT (In basis points)

Enterprise	Spread
Five-Year Maturity	
Fannie Mae	34
Federal Home Loan Banks	41
Sallie Mae	41
Farm Credit System	41
Thirty-Year Maturity	
Fannie Mae	42
Freddie Mac (subordinated)	49

SOURCE: Congressional Budget Office based on information from the trading desk, Salomon Brothers. Yields are as of 1:00 p.m., April 12, 1989.

of the FCS's portfolio of farm and cooperative loans and agricultural mortgages is sensitive to fluctuations in farm income and farm real estate values.

Federal regulation is the most important means of controlling the risks of government-sponsored enterprises. Four of the five active GSEs have federal regulators. The Federal Home Loan Bank Board has broad authority to regulate the FHLBs, and its members constitute the board of directors of, and thus directly control, Freddie Mac. The Department of Education has no authority to regulate Sallie Mae. The Department of Housing and Urban Development (HUD) has general regulatory authority over Fannie Mae, but this power extends to the internal affairs of the GSE only when necessary to protect the financial interests of the government. HUD also may limit Fannie Mae's debt-to-capital ratio. This authority is of little value, however, because the enterprise's subordinated debt, which carries an implicit federal guarantee, is considered to be capital. The Farm Credit Administration (FCA) has authority to assure the safety and soundness of FCS member institutions, including the power to prescribe minimum capital levels. The FCA will also regulate the safety and soundness of Farmer Mac when that GSE begins operating.

Last year, this Committee considered but did not approve legislation that would have created a new GSE--the Corporation for Small Business Investment (COSBI). The government would have provided over 95 percent of COSBI's capital. COSBI would have financed Small Business Investment Company debentures, which are very risky assets. The corporation also would have been free to assume interest-rate risk. The bill would have authorized the Secretary of the Treasury to disapprove any debt or guarantees issued by COSBI that would have impaired its financial safety and soundness, but it is uncertain whether he could have used this authority to limit the credit or interest-rate risk assumed by the corporation.

Government-Sponsored Enterprises in the Federal Budget

Other than the annual reports of government-sponsored enterprises, federal budget documents are the principal source of public information on their activities. As I noted earlier, the budget authority and outlay totals in the unified budget do not include the spending of sponsored enterprises. However, the *Appendix* to the President's budget includes summary financial information about each GSE and a projection of its aggregate borrowing and lending during the budget year. Discussions of each enterprise--the government's implicit guarantee of its securities, the legal benefits that it enjoys under federal law, and its lending and borrowing--appear in the *Special Analyses* volume of the budget. In the *Special Analyses* volume and the *Statement of Liabilities and Other Financial Commitments of the United States Government* published by the Treasury each year, GSE borrowings and guaranteed mortgage-backed securities are not considered to be contingent liabilities of the government, because the implicit federal guarantee is not legally binding.

The budget documents, like the annual reports of GSEs, present the activities and financial condition of GSEs in accordance with Generally Accepted Accounting Principles (GAAP) for private firms, which measure assets, liabilities, and capital on a book-value basis. Financial information based on book values cannot be used to measure accurately the financial risk of a financial intermediary. Accurate measurement of risk requires estimates of the marked-to-market net worth of the firm and of the uncertainty of its future performance. In 1986, the government published estimates of the marked-to-market net worth of one GSE, Fannie Mae. At present, no effort is being made to estimate this variable for the other enterprises, or to quantify the risks that the five active GSEs pose to the government.

Borrowing by Government-Sponsored Enterprises and by the Treasury

The outstanding debt and mortgage-backed securities of GSEs have increased at an extraordinarily rapid rate--18 percent a year on average since 1970. This growth has made the implicit federal guarantee of sponsored enterprises a significant form of government intervention in the credit markets. As shown in Table 3, at the end of fiscal year 1988, outstanding GSE debt and mortgage-backed securities totaled over $720 billion. This amount was more than one-third of the outstanding federal debt held by the public and 8 percent of total debt outstanding in the United States. As shown in Figure 1, in recent years the amount of new debt issued and mortgage-backed securities guaranteed by GSEs has exceeded 50 percent of Treasury borrowing from the public.

TABLE 3. GSE SECURITIES OUTSTANDING AT END OF YEAR
(In billions of dollars)

	1970	1975	1980	1985	1986	1987	1988	Estimated 1989	Estimated 1990
Farm Credit System									
Banks for Cooperatives	1.5	3.2	8.4	8.1	8.5	8.9	11.2	11.1	11.7
Farm Credit Banks[a]	11.3	23.7	53.6	61.8	55.6	35.3	43.4	42.0	42.0
Federal Home Loan Bank System									
Banks	11.2	20.6	36.6	73.6	88.1	105.1	126.7	145.0	160.0
Freddie Mac									
Debt	b	5.1	4.7	13.8	14.9	17.1	20.6	22.6	22.4
Mortgage-backed securities	b	1.2	16.8	92.0	146.9	208.9	220.7	252.7	279.5
Fannie Mae									
Debt	13.2	28.2	52.3	91.7	91.6	92.6	106.0	103.8	106.5
Mortgage-backed securities	b	b	b	48.8	86.4	130.5	167.2	185.3	205.7
Sallie Mae	b	0.2	2.3	12.7	15.5	21.3	25.0	29.1	33.5
Total	37.2	82.3	174.8	402.4	507.5	619.7	720.7	791.6	861.3

SOURCE: Congressional Budget Office based on information from the Office of Management and Budget.

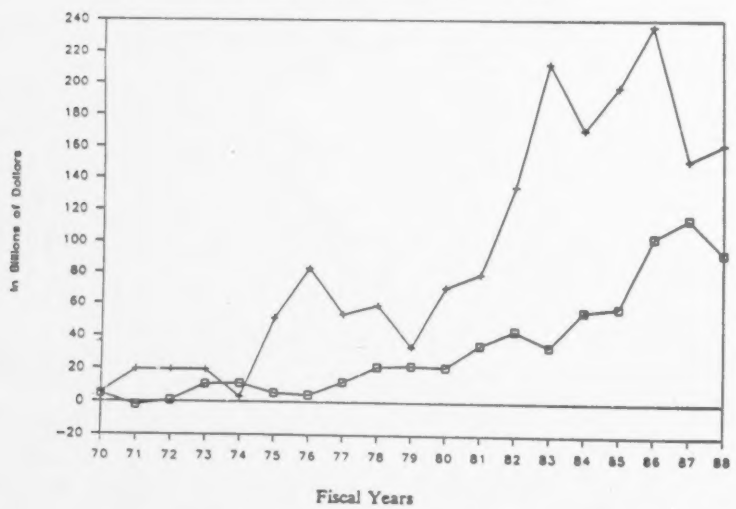
a. Before fiscal year 1987. Includes the Federal Intermediate Credit Banks and the Federal Land Banks.

b. Not yet chartered.

Considering the amount of borrowing by GSEs, it is reasonable to ask whether intermediation by GSEs raises the interest rates that the Treasury must pay to borrow. Broadly speaking, the answer is "No, or not by much." Overall, GSE operations should have little effect on interest rates. While GSE borrowing may raise rates, subsequent relending of the proceeds should reduce rates in an offsetting way. There is a possibility of some net upward pressure on Treasury rates, since securities *issued* by GSEs are apparently closer substitutes for Treasury debt in the eyes of the investors than are the securities that GSEs purchase when relending their funds. Evidence shows, however, that these factors lead only to temporary upward pressures on Treasury rates.

The main issue determining whether GSE operations raise Treasury and other interest rates has to do with whether GSEs result in more borrowing by farmers, students, homebuyers, and other assisted parties than would have been true if GSEs did not exist, and whether any such increases in borrowing are offset by a rationing of credit to other borrowers. If there is an increase in overall borrowing by the parties assisted by GSEs, it is likely that interest rates--for Treasury securities and other instruments--will be higher than they would otherwise have been. As yet, however, little evidence exists on

Figure 1. New GSE and Treasury Borrowing From the Public



Source: Congressional Budget office based on information from the Office of Management and Budget.

this issue. Many analysts believe that the increase in net borrowing caused by GSEs is slight. If this is true, any upward pressure on Treasury borrowing rates is likely to be slight as well.

OFF-BUDGET BORROWING CORPORATIONS

In 1987, the government began to create off-budget borrowing corporations to finance the liquidation, outside the federal budget, of losses previously realized by the government. The losses had been incurred on risks assumed by the government through the implicit federal guarantee of the liabilities of GSEs and federal insurance of deposits at savings and loans. The government created the first of these--the Financing Corporation (FICO)--in 1987 to raise money to enable the Federal Savings and Loan Insurance Corporation (FSLIC) to resolve insolvent thrifts. Early in 1988, the Financial Assistance Corporation (FAC) was authorized to finance assistance to ailing parts of the Farm Credit System.

FICO and FAC were given federal charters and nearly all the other legal attributes of government-sponsored enterprises. Two GSEs--the FHLBs and the FCS member institutions--were required by law to contribute funds to the new borrowing corporations. The mandatory contributions were defined in law to be purchases of stock in FICO and FAC. The stipulation created the appearance that they would be privately owned financial intermediaries. This appearance was used as an argument for calling the borrowing corporations GSEs and excluding them from the federal budget.

The Administration's bill to address the savings and loan crisis would authorize a new borrowing corporation, REFCORP, to raise $50 billion over three years to finance thrift resolutions. REFCORP would continue the practice begun with FICO and FAC and would greatly increase the use of off-budget borrowing to liquidate losses from government guarantees.

The emergence of borrowing corporations raises the question of how they should be treated in the budget. The President's Commission on Budget Concepts did not envision the creation of entities like FICO, FAC, or REFCORP. Nor is it likely to have foreseen the incentive that its "private ownership" criterion and the Balanced Budget Act now provide to create such entities.

There are numerous arguments for considering the borrowing corporations to be parts of the federal government, and for including their borrowing and spending in the unified budget. The case of REFCORP can be used to illustrate this point. The government would create the corporation for the sole purpose of borrowing funds and transferring them to a federal agency--namely, the Resolution Trust Corporation (RTC). REFCORP's actions would be controlled by the RTC Oversight Board, which would consist of three federal officials. Although the bill would designate the transfer of FHLB earnings to REFCORP as purchases of "nonvoting capital stock" in the latter, the FHLBs could not be paid "dividends" on the "stock" or otherwise benefit financially from REFCORP's activities. Furthermore, they

could not recoup the money they contributed. The federal government would be the sole beneficiary of the existence of REFCORP and the contribution of funds by the FHLBs. The Administration's proposal would give REFCORP the authority to levy and collect assessments on federally insured thrifts. These assessments would be indistinguishable from those collected by federal agencies and included in the budget. Finally, payments by the Treasury, not these assessments, would finance over 90 percent of REFCORP's debt.

A reasonable conclusion from these facts is that REFCORP should be treated as part of the federal government, rather than as a GSE. Ultimately, the Congress and the President will decide how REFCORP and the other borrowing corporations are to be classified. If the decision is made to treat REFCORP as part of the government, the question remains whether the spending it financed should be counted in deficit calculations under the Balanced Budget Act. I will return to that issue later in my statement.

THE BENEFITS AND COSTS OF OFF-BUDGET BORROWING CORPORATIONS

The purpose of using FICO, FAC, and REFCORP to liquidate losses realized on federal guarantees is to prevent the spending so financed from causing a large, short-term increase in federal outlays and the deficit. The borrowing corporations shift the recognition of nearly all of these costs far into the future. This result is accomplished by showing in the budget only the relatively small annual amounts that the government will pay to service and retire the debt of the borrowing corporations. The larger initial expenditure of the borrowed funds does not add to budget outlays.

This practice has both positive and negative consequences. On the plus side, limiting any short-term budgetary impact to the government's portion of the interest payments minimizes the effect of the spending on the baseline deficits calculated under the Balanced Budget Act.

On the minus side, the approach is inconsistent with the concept of the unified budget. It also tends to reinforce the misconception that federal guarantees of the liabilities of private financial intermediaries are not very risky--a view that makes it less likely that the government will improve existing, or develop new, regulatory or budgetary means to control that risk.

FICO, FAC, and the proposed REFCORP also raise the cost of financing the liquidation of the government's losses, relative to borrowing the funds through the Treasury. The spreads between the market yields of FICO bonds and Treasuries with comparable maturities have ranged from 55 to 100 basis points. CBO estimates that REFCORP would pay between 20 and 40 basis points more to borrow than the Treasury. This difference would raise the cost of the interest payments on $50 billion in debt by between $100 million and $200 million a year, or by $1 billion and $2 billion in present value

terms. Finally, borrowing through off-budget corporations reduces the Treasury's control over debt issued to finance federal spending.

The Administration has argued that the $1 billion to $2 billion more that REFCORP borrowing will cost is an acceptable price to pay to preserve the credibility of the government's commitment to achieve the Balanced Budget Act deficit targets. In CBO's view, this argument gives too little weight to the acumen of Wall Street analysts, who surely recognize that to treat REFCORP borrowing as if no binding federal obligation were involved is merely an expensive way to exalt form over substance in a manner that will provide no discernible benefit to the taxpayers.

POLICY OPTIONS FOR THE CONGRESS

Both GSEs and the newer borrowing corporations impose costs on the government, but the means of controlling those costs differ.

Controlling the Risk of Government-Sponsored Enterprises

Controlling the cost of federal risk-bearing for GSEs requires limiting their risk. Basically, the government can use three policy tools to assess and control risk. First, government officials can closely monitor the activities and accurately measure the marked-to-market net worth and risk of GSEs. Second, regulators can require the enterprises to maintain sufficient capital to ensure that any losses they incur will be borne by owners, not the government. Third, regulators can impose management controls on GSEs that are losing money before the institutions become insolvent.

The government has recently taken steps to improve the use of these tools to control the risks posed by federally insured depository institutions. Last year, banking regulators in the United States and several other nations agreed to a risk-based capital requirement of 8 percent for commercial banks, which will be phased in by the end of 1992. The Federal Home Loan Bank Board has proposed risk-based capital standards for thrifts. In order to implement risk-based capital requirements, federal banking regulators and the Bank Board are improving their ability to monitor the marked-to-market net worth and the risk of insured depository institutions. The Administration has proposed that by 1991, federally insured thrifts must--as banks do now--maintain capital of not less than 6 percent. The Federal Deposit Insurance Corporation (FDIC) recently took control of a thrift that was not insolvent, but which FDIC felt was engaged in management practices that were too risky.

The government could use these and related policy tools to measure and control the risks posed by government-sponsored enterprises. Continuing the current policy of not measuring or controlling the risks of GSEs could lead to large, unanticipated federal outlays, similar to the assistance provided to the Farm Credit System in 1988. One approach would be to authorize a single agency, such as

the Treasury, to collect and analyze information about the risks of each GSE and to issue and enforce regulations that control the risks borne by the government.

The implicit federal guarantee of the liabilities of a GSE has a subsidy cost to the government, just as does an explicit federal guarantee of a single loan to a single borrower. If the government regularly collected detailed information about the risk and marked-to-market net worth of each GSE, that data could be used to calculate the subsidy cost of the implicit federal guarantee. This cost could be included in the unified budget or the budget documents and compared with the cost of other federal spending and credit assistance.

Two other approaches exist to control the risks that GSEs impose on the government: charge them risk-related user fees, or remove all the special benefits they enjoy under federal law. The Reagan Administration proposed several different versions of user fees for GSEs and endorsed severing the government's ties to Fannie Mae and Freddie Mac, but the Congress has not enacted either policy. Calculating user fees that accurately reflected the risks of GSEs would require collecting the same information and performing the same analyses that would be needed in order to improve oversight and regulation of GSEs and to calculate the subsidy cost of federal risk-bearing.

Sponsored Enterprises or Explicit Federal Guarantees?

In CBO's view, the most important factor in the decision to use an off-budget sponsored enterprise or an on-budget program of explicit federal guarantees is whether the government can measure and control the cost of subsidizing the assisted parties. If the costs to the government of explicit federal guarantees and of GSEs were equally well measured and controlled, then from a budget process point of view there would be no difference between either policy instrument. However, although the budgetary treatment and control of on-budget credit programs have many defects, at this point they are far superior to the budgetary treatment and control of GSEs. Until the measurement and control of GSE risk and cost is improved, the Congress may want to exercise great caution in creating new GSEs or expanding the powers of existing ones.

Limiting the Cost of Federal Borrowing

The cheapest way for the government to borrow to finance the liquidation of losses arising from federal guarantees is through the Treasury. The higher cost of using REFCORP to borrow $50 billion to resolve insolvent thrifts--$1 billion to $2 billion in present value terms--could be saved by having Treasury borrow the money. This approach could be combined with a decision to exclude the spending so financed, but not the Treasury interest payments on the borrowing, from the baseline budget deficit calculations under the Balanced Budget Act.

The exclusion could be justified by the nature of the economic effects of the spending and borrowing. Increases in the federal deficit to finance resolution of insolvent thrifts have few of the adverse economic effects of ordinary federal deficits. Unlike much of the present federal deficit, federal borrowing for thrift resolution does not detract from national saving. As a result, borrowing for thrift resolution does not raise interest rates, increase the trade deficit, or reduce living standards for future generations--aspects of existing federal deficits that have long troubled many observers. Thrift-related deficits also do not increase aggregate demand, and thus do not exacerbate the inflationary pressures that have become a growing concern during the past year. Moreover, borrowing the money would have no permanent structural effect on the deficit beyond the interest payments on the debt issued.

CONCLUSION

In conclusion, Mr. Chairman, let me recapitulate the main points I have made this morning.

- Government-sponsored enterprises are an important type of federal credit assistance, but they expose the government to considerable financial risk. The Congress could reduce the likelihood of more financial assistance being provided to troubled GSEs in the future by improving ways to measure and control their risk.

- Off-budget borrowing corporations such as REFCORP raise the cost of financing the liquidation of losses arising from federal guarantees, at no discernible benefit to taxpayers. By having the Treasury raise the funds, the Congress could save the higher cost and maintain Treasury control over federal borrowing.

Chairman ROSTENKOWSKI. Thank you.

In 1974, Bob, the Committee on Ways and Means created the Federal Financing Bank so that the Federal agency could reduce the cost of their borrowing by borrowing through the Treasury Department. Is there any policy reason to abandon this practice in the case of the RefCorp debt?

Mr. REISCHAUER. It is an erosion of the principles set down in 1974. The more we turn to borrowing corporations that are off-budget, and the more we allow these entities to go into capital markets on their own, the less relative importance the Federal Financing Bank will have overall in borrowing for governmental purposes.

Chairman ROSTENKOWSKI. Mr. Gradison.

Mr. GRADISON. Thank you, Mr. Chairman.

In your judgment, is the administration's FSLIC financing plan adequate to cover the costs of the savings and loan problem as we measure it today?

Mr. REISCHAUER. CBO has just submitted to the appropriate committees its cost estimate on the bill now being debated on the Senate floor. Our best estimate would be that more resources will be needed, but no one can answer that question with certainty. Fifty billion dollars is certainly near the low end of reasonable judgments on what the ultimate resolution costs will be.

CBO's current estimate is $15 billion higher. Maybe James Blum—and I apologize for not introducing him previously—would want to add to that. Jim has been responsible for the numerous evaluations made by CBO over the last few months of the savings and loan situation, and has testified a number of times on this issue.

Mr. BLUM. Thank you.

Mr. Gradison, the Senate bill actually limits the additional borrowing, or the amount of money the Treasury can provide directly for case resolution costs, to $24 billion. The money is in addition to the $50 billion that is authorized to be borrowed through RefCorp. This $24 billion cap is in place through 1999.

We estimate that the Treasury will have to use some of that money within the next 5 years. The $50 billion will not be sufficient to solve all of the existing and prospective savings and loan problems.

Mr. GRADISON. The Senate bill, then, as you analyze it, is inadequate to deal with the problem? Is that correct?

Mr. BLUM. It is inadequate in the sense that it may not be sufficient to cover all of the costs that may arise over the next 10 years. We think that the $50 billion of the RefCorp borrowing that is authorized, plus the additional $24 from the Treasury, will be enough for the next 5 years.

Mr. GRADISON. Let's assume that the administration prevails with regard to the financing that is set up as they suggest with RefCorp. Let's imagine it is a year from now and you are preparing budget figures for us. Are you going to score this activity as on-budget based on the testimony you have given if it is written the way in which the administration has suggested?

Mr. REISCHAUER. How this bill is scored eventually is a political decision that will be determined by the Congress and the Budget

Committees. Until we are ordered otherwise, we will continue to score it as we have so far, as an on-budget activity.

Mr. GRADISON. Thank you very much.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. McGrath.

Mr. MCGRATH. Thank you, Mr. Chairman.

I have no questions except to congratulate Bob.

Mr. REISCHAUER. Thank you.

Chairman ROSTENKOWSKI. You know Treasury, Bob, argues that putting RefCorp on-budget would cause bad market reaction due to a so-called loss of discipline and Gramm-Rudman.

If RefCorp really is a Federal agency and Treasury pays most of the cost, won't the markets figure this out?

Mr. REISCHAUER. Mr. Chairman, you and I seem to have a higher view of the intelligence of Wall Street than do the Treasury and OMB. I think the markets understand what RefCorp is already, and their behavior indicates that.

I had better stop at that point.

Chairman ROSTENKOWSKI. Well, there will be no further questions.

Thank you very much for joining us. I look forward to working with you, Bob.

Mr. Seidman, Mr. Ely, Mr. Stanton, Ms. Ettleson.

[Pause.]

Chairman ROSTENKOWSKI. Thank you all for joining us this afternoon. I think you are all aware of what our procedure is. If your statement is longer than the time allotted please summarize and we will include your entire statement in the record. We will go through each individual witness and then sum it up with some questions from the members.

Mr. Seidman, if you are ready to give your testimony the committee is ready to receive it.

STATEMENT OF HAROLD SEIDMAN, PH.D., FELLOW, NATIONAL ACADEMY OF PUBLIC ADMINISTRATION

Mr. SEIDMAN. Yes, Mr. Chairman.

Mr. Chairman and members of the committee, I am pleased to accept your committee's invitation to discuss a number of issues related to the utilization, organization, financing, and control of Government enterprises. My testimony represents my individual views and does not necessarily reflect the views either of the National Academy of Public Administration or its fellows.

The blurring of the dividing line between what is Government and what is private is evidenced by the proliferation since 1968 of highly diverse organizations loosely termed Government-sponsored private enterprises. These include not only the financial intermediaries classified as Government-sponsored enterprises by the Office of Management and Budget, but also other legally designated private or non-Government organizations which enjoy a special relationship with the Government such as the Corporation for Public Broadcasting, Legal Services Corporation, and the Securities Investor Protection Corporation.

H.R. 1287 and S. 413, the administration's savings and loan reform bill now before the Congress would establish two more GSE's: the Resolution Trust Corporation and Resolution Funding Corporation to manage failed savings and loans and their assets and to provide for off-budget financing of the bailout of the federally insured institutions.

At one time there was no question that an agency created by the Congress for a public purpose directed and controlled by Federal officers and funded directly or indirectly by the Treasury was a Government agency. Those were the criteria used 44 years ago when the Supreme Court, in the case of *Cherry Cotton Mills* v. *U.S.* held that designation of the Reconstruction Finance Corporation as a corporation did not, and I quote "alter its characteristic so as to make it something other than what it actually is: An agency selected by the Government to accomplish purely governmental purposes."

I believe that these tests for determining legal status remain valid. Applied to Government-sponsored enterprises it is evident that most of them are mislabeled as non-Government. The Resolution Trust Corporation, which would be established under section 501 of S. 413 and H.R. 1287 provides the most recent example of the frivolous designation of an agency as a non-Government simply to evade budgetary and other controls.

Section 501 states that the oversight board and corporation shall not be an agency or executive agency for purposes of title V of the United States Code. The Resolution Trust Corporation is to be established for a public purpose wholly owned by the U.S. Government, controlled by an oversight board consisting of the Secretary of the Treasury, Chairman of the Federal Reserve Board, and Attorney General, and authorized to borrow $5 billion from the Treasury.

The Resolution Funding Corporation, the shell corporation without employees, established by section 502 to fund the Resolution Trust Corporation is classified as a mixed ownership Government corporation, although the nonvoting capital stock, which the Federal home loan banks are required to subscribe confers none of the normal rights of ownership.

Government-sponsored enterprises are not a single class of institutions with common purposes operating or financial requirements. Only a few of them actually have genuine stock ownership. And the others have stockholders who are required by law to invest, which is not the usual way we have people investing in private corporations.

The Corporation for Public Broadcasting and the Legal Services Corporation are not revenue producing and self-sustaining enterprises and are financed by annual appropriations, grants, gifts and reimbursements.

The profound constitutional and legal consequences of defining these enterprises as either private or non-Federal agencies are not well understood. Private individuals and agencies are not subject to the same body of laws. Federal agencies, their officers, and employees. The laws applicable to the Government are intended to prevent abuse of power and to assure fairness and openness in the administration of laws, honesty, integrity, and competence of public

officers and employees, and accountability to duly elected officials and the citizens.

Except for the prohibition of slavery the restraints, such as the due process law, provided by the U.S. Constitution apply only to the Government. As non-Federal agencies, presumably Government-sponsored enterprises and their employees are not subject to such laws as those relating to conflicts of interest, security, and freedom of information, and unless their enabling statutes specifically so provide.

Exemption from laws applicable to Federal agencies and employees does not mean that GSE's are subject to the laws and regulations applicable to comparable organizations in the private sector. Many are expressly exempted from such laws and regulations and they function in a terra incognita where they may and do claim whatever legal status best suits their purposes at the moment.

They are private agencies when dealing with Federal regulators and Government agencies when dealing with local taxing authorities.

Neither the President nor the Congress has attempted to develop consistent criteria for the use of GSE's or specially designed systems to assure appropriate accountability and control as was done for Government corporations.

On the contrary, the principal criteria appear to be political expediency and the desire to finance programs off-budget and to evade pay caps, personnel ceilings, and the multitude of controls now imposed by the Executive and the Congress which make it difficult for Government agencies to function effectively.

To gain short-term advantages by concealing through various means the budgetary costs of proposed programs we may be incurring greatly increased future costs for the Treasury and the taxpayer. An example of this we have heard about today is the use of borrowing directly from the public instead of going through the Treasury or the Federal financing bank to conceal the deficit.

The Congress has pursued contradictory policies. It has demonstrated great ingenuity in inventing institutions to circumvent the laws that it has enacted. It is by no means a coincidence that the Federal National Mortgage Association was converted from a Government corporation to a GSE in 1968 following adoption of the unified budget, which for the first time included trust funds and expenditures from Fannie Mae's secondary market operations.

Since 1968, the Congressional Budget Act, the Gramm-Rudman-Hollings Act, and other restrictive budgetary measures have produced increased pressure to find ways and means to finance programs off-budget with the resulting proliferation of GSE's.

Within the last 2 years, four new GSE's were created and more would established by legislation pending before Congress. The GSE's ambiguous legal status in no way reduces the Federal Government's enormous stake in their operations. The profitmaking enterprises retain privileges normally reserved for Government agencies which are not enjoyed by their private competitors. Fannie Mae contends that it would have to go out of business if it lost these privileges.

Perhaps most important, the financial community assumes that the GSE's obligations, although not guaranteed by the Government

or backed by the full faith and credit of the United States have the implicit support of the U.S. Government which is seen as not willing to permit the enterprises to go bankrupt.

This perception is reinforced by the appointment of Government directors. Yet at present the Government fails to exercise effective oversight of these enterprises and appears to lack either the means or the will to identify and solve problems before being confronted with major crises. We do not have an accurate estimate of the massive and escalating contingent U.S. liability being generated by these enterprises.

It is argued that GSE activities should be off-budget because they have no macroeconomic effects, but this reflects a highly limited view of the purposes of the budget and the budget process. Properly utilized, the annual budget review provides the best opportunity for the Congress and the President to evaluate programs and to obtain answers to the tough questions which should be asked by a responsible board of directors. It enables the Congress and the President to take necessary action before, not after the fact.

Regrettably, in recent years the budget process has focused mainly on playing the numbers game with decreasing attention to program analysis and evaluation. The Congress is now faced with the equally undesirable alternatives of either subjecting GSE's to those budget controls designed for programs which are not intended to operate as self-sustaining businesses or exempting them altogether.

The issue is not whether the GSE should be on-budget but how they should be included in the budget. When it enacted the Government Corporation Control Act of 1945, the Congress recognized that it would be self-defeating to deprive revenue producing enterprises of the flexibility to respond to market demand by subjecting them to annual expenditure limitations.

Under the Government Corporation Control Act, wholly-owned Government corporations are required to submit for review by the President and the Congress annual business-type budgets which the act provides shall be plans of operations with due allowance flexibility. The business-type budget calls for qualitative rather than the quantitative examination of corporate financial operations. The budget review necessarily balances revenues against expenditures, and only net results of corporate operations are included in the budget totals.

If we concentrate exclusively on budget outlays then we are likely to ignore those corporate policies which may result in ultimate cost to the Treasury and the taxpayer—demand projections, price structure, credit standards, criteria for capital investments, disposition of surplus, or loss and management efficiency.

In 1958 and 1959 budget messages, President Eisenhower recommended that the Government Corporation Control Act be amended to provide for budget review and audit control of Government corporations which are authorized directly or indirectly to obtain and utilize Federal funds. The distinction made in the control act between wholly-owned and mixed-ownership Government corporations was not believed to provide a satisfactory criterion for determining the potential Government risk exposure and the need for budget review.

The principal target at the time of the proposed amendment, introduced in the 85th Congress as H.R. 8332, was the farm credit banks, which even then were lending money at lower interest rates than they were borrowing. A number of the mixed ownership corporations are now classified as GSE's.

The committee should be aware that one of the consequences of merging the Federal Savings and Loan Insurance Corporation with the Federal Deposit Insurance Corporation is to convert it to a mixed-ownership corporation which would not be required to submit a business-type budget or be subject to annual audit by the Comptroller General.

Actions taken by the Office of Management and Budget and Congress during the last decade have not been wholly consistent with the letter and spirit of the Government Corporation Control Act. The 1981 National Academy of Public Administration report on Government corporations specifically criticized the failure by OMB and Congress to maintain specialized staff competent to evaluate corporate budgets. Instead of strengthening the Government Corporation Control Act, the act has been weakened by amendments—triennial audits replaced annual audits—and by not amending the act to include new corporations. Of the over 30 corporations created by the Congress since the mid-1960's, a majority are not subject to the Government Corporation Control Act.

GSE's are now placed in a position where they are able to exploit the ambiguity of their legal status to eliminate or reduce accountability to the Congress, their shareholders when they have them, and the public. The purposes which Congress sought to accomplish by creating these organizations can be better achieved without sacrificing accountability or blurring the dividing line between what is Government and what is private. The trend toward establishing more GSE's to evade Government controls or regulations constitutes a potential threat to responsible democratic Government.

Thank you, Mr. Chairman.

[The statement of Mr. Seidman follows:]

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TESTIMONY OF HAROLD SEIDMAN, FELLOW
NATIONAL ACADEMY OF PUBLIC ADMINISTRATION

April 18, 1989

Mr. Chairman and Members of the Committee:

My name is Harold Seidman. I am a Fellow of the National Academy of Public Administration and currently a guest scholar at the Center for the Study of American Government, The Johns Hopkins University. As government corporation specialist and later Assistant Director for Management and Organization of the Bureau of the Budget, I was responsible for implementing the Government Corporation Control Act of 1945 and advising the President and the budget director on the organization, management, financing and control of government corporations and unincorporated public enterprises.

The National Academy of Public Administration is a nonpartisan organization formed in 1967 to advance the effectiveness of public management through advice and counsel to all levels of government. In 1984 the Academy was chartered by act of Congress, the first such charter granted by Congress since the charter for the National Academy of Sciences in 1863. Throughout its history, the Academy has maintained a strong interest in government organization. One example is a 1981 report on government corporations which provided a comprehensive analysis of 35 such corporations then in existance.

I am pleased to accept your committee's invitation to discuss a number of issues related to the utilization, organization, financing and control of government-sponsored enterprises (GSEs). My testimony represents my individual views and does not necessarily reflect the views of either the National Academy of Public Administration or its Fellows.

The blurring of the dividing line between what is government and what is private is evidenced by the proliferation since 1968 of a group of highly diverse organizations loosely termed "government-sponsored private enterprises." These include not only the financial intermediates classified as government-sponsored enterprises by the Office of Management and Budget (Student Loan Marketing Association, Federal National Mortgage Association, College Construction Loan Insurance Corporation, banks for cooperatives, farm credit banks, Federal Agricultural Mortgage Corporation, Farm Credit System Financial Assistance Corporation, federal home loan banks, and Financing Corporation) but also other legally designated "private" or "non-government" organizations which enjoy a "special relationship" with the government such as the Community Development Corporation, Corporation for Public Broadcasting, National Home Ownership Foundation, National Park Foundation, Neighborhood Reinvestment Corporation, and Securities Investor Protection Corporation. H.R. 1287 and S.413, the Administration's savings and loan reform bill now before the Congress, would establish two more GSEs, the Resolution Trust Corporation and Resolution Funding Corporation to manage failed savings and loans and their assets and to provide for off-budget financing of the bailout of the federally insured institutions.

At one time there was no question that an agency created by the Congress for a public purpose, directed and controlled by federal officers, and funded directly or indirectly by the Treasury was a government agency. These were the criteria used forty-four years ago when the Supreme Court, in the case of Cherry Cotton Mills vs. U.S. [1945], held that the designation of the Reconstruction Finance Corporation as a corporation did not "alter its characteristics so as to make it something other than what it actually is, an agency selected by the government to accomplish purely governmental purposes." I believe that this test for determining legal status remains valid. If applied to government-sponsored enterprises it would become evident that most of them are mislabeled as "non-governmental."

The Resolution Trust Corporation, which would be established under sec. 501 of S. 413 and H.R. 1287, provides the most recent example of the frivolous designation of an agency as "non-government" simply to evade budgetary and other controls. Sec. 501 states that "the Oversight Board and Corporation shall not be an 'agency' or 'executive agency' for purposes of Title 5, United States Code." The Resolution Trust Corporation is to be established for a public purpose, wholly owned by the U.S. government, controlled by an Oversight Board consisting of the Secretary of the Treasury, Chairman of the Federal Reserve Board, and Attorney General, and authorized to borrow $5 billion from the Treasury. The Resolution Funding Corporation, the shell corporation without employees, established by sec. 502 to fund the Resolution Trust Corporation, is classified as a mixed-ownership government corporation, although the non-voting capital stock which the Federal Home Loan Banks are required to subscribe confers none of the normal rights of ownership.

Government-sponsored private enterprises are not a single class of institutions with common purposes, operating and financial requirements. Only the Federal National Mortgage Association, Student Loan Marketing Association, Federal Agricultural Mortgage Corporation and College Construction Loan Insurance Corporation issue stock which may be purchased by private investors. Corporations such as the Legal Services Corporation and Corporation for Public Broadcasting are not revenue-producing and self-sustaining enterprises and are financed by annual appropriations, grants, gifts and reimbursements. All that they share is non-government status and exemption from most, but not all, laws and regulations applicable to federal agencies, officers and employees.

The profound constitutional and legal consequences of defining these enterprises as either private or non-federal agencies are not well understood. Private individuals and agencies are not subject to the same body of laws as federal agencies, their officers and employees. The laws applicable to government are intended to prevent abuse of power and to assure fairness and openness in the administration of laws; honesty, integrity, and competence of public officers and employees; and accountability to duly elected officials and the citizens. Except for the prohibition of slavery, the restraints (due process for example) provided by the U.S. Constitution apply only to the government. As non-federal agencies, presumably government-sponsored enterprises and their employees are not subject to laws such as those relating to conflicts of interest, security, and freedom of information unless their enabling statutes specifically so provide.

Exemption from laws applicable to federal agencies and employees does not mean that GSEs are subject to the laws and regulations applicable to comparable organizations in the private sector. Many are expressly exempted from such laws and regulations, and they function in a terra incognita where they may and do claim whatever legal status best suits their purposes at the moment. They are private agencies when dealing with federal regulators and government agencies when dealing with local taxing authorities.

Neither the President nor the Congress has attempted to develop consistent criteria for the use of GSEs or specially designed systems to assure appropriate accountability and control, as was done for government corporations. On the contrary, the principal criteria appear to be political expediency and the desire to finance programs "off-budget" and to evade pay caps, personnel ceilings and the multitude of controls now imposed by the executive and the Congress which make it difficult for government agencies to function effectively. To gain short-term advantages by concealing through various means the budgetary costs of proposed programs, we may be incurring greatly increased future costs for the Treasury and the taxpayer.

The Congress has pursued contradictory policies. It has demonstrated great ingenuity in inventing institutions to circumvent the laws it has enacted. It is by no means a coincidence that the Federal National Mortgage Association was converted from a government corporation to a GSE in 1968 following adoption of the unified budget, which for the first time, included trust funds and expenditures for Fannie Mae's secondary market operations. It was argued by sponsors of the legislation that it was necessary to avoid "the vagaries of the budget situation" by financing Fannie Mae "outside the budget." Since 1968, the Congressional Budget Act, the Gramm-Rudman-Hollings Act and other restrictive budgetary measures have produced increased pressure to find ways and means to finance programs "off budget," with the resultant proliferation of GSEs. Within the last two years, four new GSEs were created and more would be established by HR. 1287 and S. 413.

The GSEs' ambiguous legal status in no way reduces the federal government's enormous stake in their operations. The profit-making enterprises retain privileges normally reserved for government agencies — lines of credit with the Treasury, tax exemptions, eligibility of obligations for purchase by federal trust funds, exemption from SEC regulations — which are not enjoyed by their private competitors. Fannie Mae contends that it would have to go out of business if it lost these privileges. Perhaps most important the financial community assumes that the GSEs' obligations, although not guaranteed by the government or backed by the full faith and credit of the United States, have the implicit support of the U. S. government which is seen as not willing to permit the enterprises to go bankrupt. This perception is reinforced by the appointment of government directors. Yet at present the government fails to exercise effective oversight of these enterprises and appears to lack either the means or the will to identify and solve problems before being confronted with major crises. We do not have an accurate estimate of the massive and escalating contingent U.S. liability being generated by these enterprises, but there is no doubt that the federal government's exposure now exceeds a half-trillion dollars in outstanding debt and explicitly or "morally" guaranteed securities.

It is argued that GSE activities should be "off-budget" because they have no macroeconomic effects but this reflects a highly limited view of the purposes of the budget and the budget process. Properly utilized, the annual budget review provides the best opportunity for the Congress and the President to evaluate programs and to obtain answers to the tough questions which should be asked by a responsible board of directors. It enables the Congress and the President to take necessary action before, not after the fact. Regrettably, in recent years the budget process has focused mainly on playing the numbers game with decreasing attention to program analysis and evaluation.

The Congress is now faced with equally undesirable alternatives either of subjecting GSEs to those budget controls designed for programs which are not intended to operate as self-financing businesses, or exempting them altogether. The issue is not whether GSEs should be on budget, but how they should be included in the budget.

When it enacted the Government Corporation Control Act of 1945, the Congress recognized that it would be self-defeating to deprive revenue-producing enterprises of the flexibility to respond to market demand by subjecting them to annual expenditure limitations. As noted by the House Committee on Expenditures in Executive Departments in its report on the Act (House Report No. 856, 79th Congress), "the development of financial controls must necessarily take into account certain peculiarities of the corporate device, since to do otherwise might impair the ability of corporations to carry out their statutory responsibilities. . . . No purpose is served by restrictive limitations which would hinder a corporation in carrying out its statutory program or which might result in the submission of frequent amendments to the annual budget program."

Under the Government Corporation Control Act wholly-owned government corporations are required to submit for review by the President and the Congress annual business-type budgets which the Act provides shall be plans of operations "with due allowance for flexibility." The business-type budget calls for a qualitative rather than a quantitative examination of corporate financial operations. The budget review necessarily balances revenues against expenditures and only net results of corporate operations are included in the budget totals. If we concentrate exclusively on budget outlays, then we are likely to ignore those corporate policies which may result in ultimate costs to the Treasury and the taxpayer — demand projections, price structure, credit standards, criteria for capital investments, disposition of surplus or loss, and management efficiency.

In his 1958 and 1959 budget messages, President Eisenhower recommended that the Government Corporation Control Act be amended to provide for budget review and audit control of government corporations which are authorized, directly or indirectly, to obtain and utilize federal funds. The distinction made by the Control Act between wholly-owned and mixed-ownership corporations was not believed to provide a satisfactory criterion for determing the potential government risk exposure and the need for budget review. Corporations such as the Federal Deposit Insurance Corporation and the U.S. Railway Association were classified by law as "mixed ownership" to escape budget review even though they had no "owners" other than the U.S. government. The principal target of the proposed amendment, introduced in the 85th Congress as H.R. 8332, was the farm credit banks which even then were lending money at lower interest rates than they were borrowing. A number of mixed-ownership government corporations are now classified as GSEs. The amendment failed due to opposition by the farm credit banks.

The Committee should be aware that one of the consequences of merging the Federal Savings and Loan Insurance Corporation with the Federal Deposit Insurance Corporation is to convert it to a mixed-ownership corporation which would not be required to submit a business-type budget or be subject to annual audit by the Comptroller General.

Actions taken by the Office of Management and Budget and Congress during the last decade have not been wholly consistent with the letter and spirit of the Government Corporation Control Act. The 1981 National Academy of Public Administration report on government corporations specifically criticized the failure by OMB and Congress to maintain specialized staff competent to evaluate corporate budgets. Instead of strengthening the Government Corporation Control Act, the Act has been weakened by amendments (triennial audits replaced annual audits) and by not amending the Act to include new corporations. Of the over thirty corporations created by the Congress since the mid-1960s, a majority are not subject to the Government Corporation Control Act.

GSEs are now placed in a position where they are able to exploit the ambiguity of their legal status to eliminate or reduce accountability to the Congress, their shareholders when they have them, and the public. The purposes which Congress sought to accomplish by creating these organizations can be better achieved without sacrificing accountability or blurring the dividing line between what is government and what is private. The trend toward establishing more GSEs to evade government controls and regulations constitutes a potential threat to responsible democratic government. To quote from a report of the Senate Committee on Government Affairs (Senate Report No. 97-179, 97th Congress, 1st session) proposing the establishment of a commission on government organization:

> The erosion of accountability in government which stems from the new patterns of administration is possibly the gravest threat to the health of our system. Fragmented authority and ill-defined responsibility fosters the sense that government is out of control. Those responsible for a given issue are difficult to identify and all too often are remote and unresponsive.

This concludes my prepared statement. I would be pleased to respond to any question the Committee may have.

Chairman ROSTENKOWSKI. Mr. Ely.
Mr. ELY. Mr. Stanton has asked to go before me, and I agreed.
Chairman ROSTENKOWSKI. Mr. Stanton.

STATEMENT OF THOMAS H. STANTON, ESQ., OLWINE, CONNELLY, CHASE, O'DONNELL & WEYHER, WASHINGTON, DC

Mr. STANTON. Thank you, Mr. Chairman, members of the House Ways and Means Committee. Thank you for the invitation to testify again today on lessons from the insolvency of the Federal Savings and Loan Insurance Corporation, FSLIC.

This committee is to be commended for holding these hearings. This is the committee that pays the bills. This is the committee responsible for public debt and the Federal agency credit market. As a result, this committee has a fundamental stake in assuring that the Federal Government is in control of its contingent liabilities and that governmental and private borrowers in the Federal agency credit market are held financially accountable.

The FSLIC insolvency teaches one fundamental lesson. The Federal Government runs great risk if it extends open-ended credit support to private financial institutions and fails to regulate the safety and soundness of those institutions. In my testimony today, I would like to focus on the other major Government program with liability similar to Federal deposit insurance, the system of Government-sponsored enterprises. Today, the Government has extended its credit to back some $700 billion of enterprise securities under a regulatory system even more lax than for thrifts. It is time to impose financial accountability and take steps to limit the Federal Government's potentially open-ended risk exposure.

Enterprises need effective regulation of their safety and soundness comparable to oversight of their competitors such as banks with federally-insured deposits.

Enterprises should be subject to the kind of risk-based capital requirements and regulatory supervision the Government requires for national banks. Preferably, regulation of safety and soundness of all enterprises should be centralized in a single, capable regulator with responsibilities and powers similar to those of the FDIC or the Comptroller of the Currency.

As a first step to prevent more unpleasant surprises such as we now face from the insolvent FSLIC, the Government must promptly assess its financial exposure from its contingent liabilities. I respectfully urge this committee to request that the Treasury Department promptly prepare a report on such contingent liabilities. This report, unlike the report the Treasury already prepares pursuant to title 31, United States Code, section 331, should, to the greatest extent possible, reflect the realities of the Government's financial exposure.

The report should cover all major Federal guarantees and insurance and loan programs and Government-sponsored enterprises. As part of such a report, the Treasury should be asked to propose steps to contain Federal exposure to contingent liabilities in such a manner that the essential purpose of each program is preserved.

The Treasury should be asked to prepare the report from the perspective of a private guarantor or insurance company. When

the Federal Government provides its guarantee, it must supervise use of that guarantee in the same way that a private creditor protects against others' misuse of its money.

Surprises, such as the escalating cost of the financial risk taking by insured thrift institutions, are expensive. By bringing the analytic capabilities of the Treasury to bear now, this committee can help to protect against such surprises in the future.

Thank you.

[The statement and attachment of Mr. Stanton follow:]

STATEMENT OF THOMAS H. STANTON
OLWINE, CONNELLY, CHASE, O'DONNELL & WEYHER

April 18, 1989

Lessons from the Insolvency of the Federal Savings and Loan Insurance Corporation (FSLIC): Government Sponsored Enterprises and the Need to Improve Financial Accountability

Mr. Chairman, Members of the House Ways and Means Committee:

Thank you for the invitation to testify today on lessons from the insolvency of the Federal Savings and Loan Insurance Corporation (FSLIC). My name is Thomas H. Stanton and I am a Washington, D.C. attorney whose practice includes a variety of matters relating to government sponsored enterprises and other financial institutions. I am speaking today on my own behalf and not for any group or any client.

The House Ways and Means Committee is to be commended for holding these hearings. This is the committee responsible for public debt and the federal agency credit market, and is the committee that ultimately will have to raise taxes to pay for federal obligations as they come due. As a result, this committee has a fundamental stake in assuring that the federal government is in control of its contingent liabilities and that governmental and private borrowers in the federal agency credit market are financially accountable.

The FSLIC insolvency teaches one fundamental lesson: The federal government runs great risk if it extends open-ended credit support to private financial institutions and fails to regulate the safety and soundness of those institutions. In my testimony today, I would like to focus on the other major government program with liability similar to federal deposit insurance--the system of government sponsored enterprises. Today the federal government has extended its credit to back some $700 billion of enterprise securities under a regulatory system even more lax than for thrifts. It is time to impose financial accountability and take steps to limit the federal government's risk exposure.

I. We Should Apply The Lessons Of The FSLIC Insolvency To Government Sponsored Enterprises

Government sponsored enterprises combine the two potentially explosive ingredients contributing to the financial collapse of FSLIC: (1) an open-ended extension of federal credit support to private financial institutions and (2) failure properly to regulate safety and soundness of those institutions. Let us take each item in turn.

A. Government sponsored enterprises rely upon open-ended access to federal credit. To safeguard against excessive financial exposure the federal government must monitor and regulate enterprise risk taking.

1. Enterprises have open-ended access to federal credit.

The six traditional government sponsored enterprises -- Fannie Mae, Freddie Mac, the Farm Credit System and Farmer Mac, the Federal Home Loan Bank System, and Sallie Mae -- are privately owned financial institutions permitted to issue virtually unlimited volumes of debt obligations and guaranteed securities in the federal agency credit market. As discussed in Appendix A to this testimony, enterprise obligations and securities benefit from an implicit federal guarantee that can reduce enterprise borrowing costs significantly.[1]

Partly because of this federal credit support, and sometimes because of other benefits such as freedom from the significant capital requirements imposed on competitors such as banks, enterprises tend to expand greatly within their permitted markets. They can become huge institutions. Fannie Mae, for example, has $112 billion of assets plus $178 billion in guaranteed mortgage-backed securities, and Freddie Mac has $34 billion of assets plus $226 billion in guaranteed securities. Sallie Mae, one of the smaller enterprises, grew by 25 percent last year and now holds $28.6 billion of assets.

The private managers of these enterprises determine how much they will grow within their available market segments; as they grow, the federal government's contingent liability expands accordingly. This is an open-ended extension of federal credit support comparable to the government's exposure from federal deposit insurance. The government's backing of enterprise obligations is, if anything, even greater than was its liability for thrift institutions. Thrift institutions had only a part of their obligations, FSLIC insured deposits up to $100,000 per account, backed by the federal government in contrast to government backing of all enterprise obligations.

2. Federal regulation of safety and soundness must compensate for the market discipline enterprises lose because of their federal credit support

The financial failure of FSLIC dramatically documents the need for effective regulation, including capital requirements, to protect the safety and soundness of institutions whose market discipline is undercut by operation of a federal guarantee.

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[1] For discussion of the implicit federal guarantee and goverment sponsored enterprises, see e.g., Michael Moran, "The Federal Sponsored Credit Agencies: An Overview," Federal Reserve Bulletin, Vol. 71, No. 6, pp. 373-378 (June 1985); and Thomas H. Stanton, "Government Sponsored Enterprises: Their Benefits and Costs as Instruments of Federal Policy," pp. 1-8, 17-18 (1988).

There is a substantial literature on the need for effective regulation to protect safety and soundness of institutions whose market discipline is undercut by operation of a federal guarantee.[2] Because of the government guarantee, investors may not care much about the creditworthiness of an enterprise or the loans it purchases or guarantees. Instead, investors will largely look to the implicit government backing for their assurance.

For a normal corporation, without such federal backing, investor concern about creditworthiness provides an important market place constraint on risk taking. First, shareholders have a long term interest in protecting and enhancing their capital investment in the company. For enterprises such as Fannie Mae and Freddie Mac however, the applicable legislation significantly reduce the financial stake of investors by permitting them to invest very little shareholder capital compared to the government's huge stake in hundreds of billions of dollars of implicitly guaranteed obligations and mortgage backed securities.[3] While enterprise management may in fact develop prudent business policies, there is considerable incentive to seek extra returns for taking excessive risks. Economists call this "moral hazard." Heads, the corporation and its shareholders win; tails, the U.S.-taxpayer pays for the big mistakes.

Market discipline normally also comes from investors other than shareholders. Without the federal government's backing, a corporation is subject to considerable restraint when it issues debt obligations or guarantees securities. Before investors rely upon an obligation or guarantee, they require assurances about the company's financial backing. Investors check not only the balance sheets of the corporation providing the obligation or guarantee but also the credit quality of the assets standing behind the obligation or guarantee. However, investors in enterprise securities are unlikely to provide such market discipline because each enterprise relies on the federal government's backing to sell

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2 Much of this literature contains lessons from federal deposit insurance. See e.g., Mark J. Flannery, "Deposit Insurance Creates a Need for Bank Regulation," pp. 17-27, Business Review, January/February 1982, Federal Reserve Bank of Philadelphia; Fischer Black, Merton H. Miller and Richard A. Posner, "An Approach to the Regulation of Bank Holding Companies," Journal of Business, Vol. 51, No. 3, (1978), pp. 379-412; Sherman J. Maisel, Ed., Risk and Capital Adequacy in Commercial Banks, especially Chapter 6 (1981); see also Kevin E. Villani, "The Federal Forecast," Secondary Mortgage Markets, Spring 1985, pp. 26-33, Federal Home Loan Mortgage Corporation; and Edward J. Kane, "Comments," pp. 181-189, The Federal National Mortgage Association in a Changing Economic Environment (Symposium), U.S. General Accounting Office, July 17, 1985.

3 Fannie Mae, for example, has only $2.3 billion of shareholder capital to support $290 billion of assets and guaranteed securities; Freddie Mac has only $1.6 billion of shareholder equity to support $260 billion of assets and guarantees. This is substantially below the risk-based capital requirements that the FDIC, Comptroller of the Currency, and Federal Reserve Board have introduced for banks to meet by 1992.

its obligations and guarantees. Investors in enterprise securities will be spared the need for much examination of the creditworthiness of the institution, its assets, or asset pools. Instead, they can be expected to rely largely upon the implicit guarantee upon which the enterprise's obligations and guarantees will be based.

Again, this means that an enterprise can take much greater risks than could a private company in this line of business without federal support. An enterprise has an extensive market for its debt obligations and guarantees even if, for example, it is undercapitalized and does not adequately police the credit quality of loans it makes or securities it guarantees.

The lesson of the FSLIC calamity is that the federal government must deal with this problem by creating a capable independent regulator to oversee safety and soundness of institutions whose obligations it supports. While regulation is not a complete substitute for market discipline as a means of protecting the safety and soundness of a government sponsored enterprise, it is essential to help protect the institution's long term viability.

B. Most government sponsored enterprises are not well regulated to assure financial safety and soundness.

Unfortunately, despite this clear lesson, most government sponsored enterprises are not subject to capable regulation of their safety and soundness. The Department of Housing and Urban Development (HUD) regulates Fannie Mae and the Farm Credit Administration regulates the farm credit institutions and Farmer Mac. The Federal Home Loan Bank Board (until it is dissolved by the pending FSLIC legislation) has had regulatory authority over the Federal Home Loan Bank System including the Financing Corporation and also has served as the Board of Directors of Freddie Mac. Sallie Mae has no financial regulator at all.

The first problem is that a regulator such as HUD lacks the resources to oversee safety and soundness of Fannie Mae and its $290 billion in assets and mortgage-backed securities. Similarly, the Federal Home Loan Bank Board, although (or perhaps because) it is Freddie Mac's Board of Directors as well as its regulator, has relied on a very small internal staff to oversee the $260 billion dollars of Freddie Mac assets and mortgage-backed securities. If HUD assumes oversight of Freddie Mac from the Bank Board, it is likely to be overwhelmed by responsibility for two enterprises with combined assets and mortgage-backed securities amounting to over half a trillion dollars.

The second problem is that regulators often lack a clear focus on safety and soundness. Often their attention is absorbed by issues relevant to their overall agency missions that can be quite different from concerns about enterprise soundness. For example, HUD tends to concentrate on national housing policies rather than on narrower matters such as Fannie Mae's financial well-being. Given HUD's

track record overseeing Fannie Mae, the U.S. General Accounting Office has called upon Congress to clarify that HUD has a regulatory responsibility for overseeing the financial soundness of Fannie Mae's activities.[4]

Fortunately, most enterprises have been well run despite the "moral hazard" created by the implicit federal guarantee and weak federal oversight. The problem is that, just as was true of thrifts, the legal confinement of enterprises to making specialized kinds of loans -- home mortgages or student loans or advances to thrift institutions, for example -- means that profitability today cannot assure financial soundness tomorrow. Because of the lack of diversity, one systematic problem with excess credit risk or interest risk or inadequate management systems can suddenly translate into substantial financial damage. It is time now, before another enterprise gets into trouble, to institute effective regulation of safety and soundness.

II. As A First Step, The Federal Government Must Assess Its Financial Exposure From Activities Of Government Sponsored Enterprises And Other Federal Credit Programs.

To prevent more unpleasant surprises such as we now face from the insolvent FSLIC, the government must promptly assess its financial exposure from its contingent liabilities. I respectfully urge this committee to request that the Treasury Department promptly prepare a report on such contingent liabilities. This report, unlike the report the Treasury Department prepares pursuant to 31 U.S.C. § 331(b)(1)(A), should, to the greatest extent possible, reflect the realities of the government's financial exposure. The report should cover all major federal guarantees and insurance and loan programs and government sponsored enterprises. Where the report analyzes the government's contingent liability from an implicit rather than explicit guarantee, the Treasury should include appropriate language disclaiming an express guarantee. Even though the government has had no formal legal responsibility to bail-out the FSLIC, it is a true contingent liability and should be accurately assessed in this Treasury report. Assessing liabilities requires assessment of the costs of future budget impact and the likelihood that such impact will occur.

As a second part of such a report, the Treasury should be asked to propose steps to contain federal exposure to contingent liabilities in such a manner that the essential purpose of each program is preserved. The Treasury should be asked to prepare the report from the perspective of a private guarantor or insurance company. When the federal government provides its guarantee, it must supervise the use of that guarantee in the same way that a private creditor protects against others' misuse of its money.

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[4] U.S. General Accounting Office, The Federal National Mortgage Association in a Changing Environment, p. 117 (1985).

Surprises such as the escalating costs of the financial risktaking by insured thrift institutions are expensive. By bringing the analytic capabilities of the Treasury to bear, this committee can help to protect against such surprises in the future.

There is precedent for such a report. The congressional tax committees, acting through the conference committee on the Revenue Act of 1971, requested the Treasury to prepare and report on tax expenditures and their costs.[5] The Congress followed up on this committee action by codifying the requirement for a tax expenditure budget in the 1974 Congressional Budget and Impoundment Control Act.

As the methodology has improved for calculating tax expenditures, the tax expenditure budget has become an increasingly useful tool for helping the Congress assess costs and benefits of trade-offs among various tax proposals. Congress now needs a similar tool to help evaluate proposals relating to federal contingent liabilities.[6]

III. Placing The FSLIC Bailout, Off-Budget Will Not Reduce The Pressure On This Committee To Raise Taxes

Largely because of Gramm-Rudman, some policymakers seem concerned to find ways to keep the FSLIC bail-out (and payment for other federal liabilities, such as the earlier insolvency of the Farm Credit System) outside of the federal budget. Such efforts are shortsighted and will not reduce pressures on the congressional tax committees to raise revenues.

A. REFCORP fails as a device to exclude losses from the federal budget.

First, losses from the Administration's proposed Resolution Funding Corporation (REFCORP) should be reported as part of the federal budget.[7] Such a result is dictated by the test of the 1967 President's Commission on Budget Concepts that an enterprise be considered off-budget only when it is "completely privately owned." It is widely accepted that the 1967 Commission criterion should determine whether a financial institution is on or off of the budget.

REFCORP clearly and unambiguously fails the private-ownership test of the 1967 Commission on Budget Concepts. It is a well-settled principle of law that the owner of property is the person or entity that has the right

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5 See Conference Report No. 92-708, Revenue Act of 1971, P.L. 92-178, Amendment No. 74, U.S. Code Congressional and Administrative News, 1971, p. 2069.

6 This is comparable to the somewhat different approach proposed for governmental credit programs. See H.R. 1127, the "Federal Credit Reform Act of 1989." Both approaches are designed to improve accountability and congressional oversight of potentially expensive extensions of federal credit.

7 This issue is more fully addressed in my testimony to the House Ways and Means Committee on March 9, 1989.

to use and enjoy the benefits of that property and that bears the risk of loss from the property.

REFCORP benefits the government; its only purpose is to raise funds for the government to close insolvent thrift institutions by paying off creditors. The government, through a federal institution known as the Resolution Trust Corporation, would control the decisions about how and when to use money from REFCORP. REFCORP is essentially a shell corporation. Unlike other enterprises, REFCORP has been designed to be a commercial failure from its inception. Under its statutory structure, it is virtually impossible for REFCORP to have a positive net worth. The federal government implicitly guarantees the principal of REFCORP obligations and explicitly guarantees the interest, and will be called upon to pay off REFCORP creditors in case of any default.

The nominal contributors of private money, the Federal Home Loan Banks, have no right to enjoy the benefits of the property or to decide how REFCORP's corporate assets will be used. They did not make an investment and will not profit from their contribution. Their contribution is mandated by law and will be determined by law as administered by a board of federal officials. This is a mandatory and involuntary assessment that is unlikely to be rebated. It is the government that owns REFCORP because the government allocates the benefits of the corporation and is responsible for the losses.

B. Our foreign creditors are not impressed by efforts to hide federal outlays off-budget.

Second, America is now a debtor nation. Our foreign creditors are imposing pressure to reduce the federal deficit. Like any capable creditors, they are carefully monitoring the government's overall financial condition. Creditors are not impressed by transparent efforts of a debtor to change accounting practices as a means of dressing financial statements. That is especially true of America's foreign creditors who are already well aware of a $50-$100 billion bail-out of the FSLIC. Indeed, one would argue that overseas readers of the Economist, published in London, for example, have been kept better informed about the dimensions of this problem than the average American taxpayer.[8]

These overseas creditors will exert pressure on the federal government to reduce the deficit regardless of the budgetary treatment of the FSLIC bail-out. It is the $50 billion or $100 billion or $150 billion actual price tag that will increase the pressures on this committee to raise

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8 To give but one example, the Economist reported on August 15, 1987, about costs of bailing out FSLIC as high as $100 billion under some circumstances. The Economist concluded that "the American thrift industry remains a time bomb. If it explodes, it could make the much-more-talked-about Third World debt problem look tiny -- at least to the American taxpayer." Economist, "Thrifts; America's Own Mine Field," August 15, 1987, pp. 60-62. This is substantially more accurate information than was then available to American taxpayers from the Federal Home Loan Bank Board.

revenues to cover the costs. Use of a government sponsored enterprise to fund FSLIC will only add to the final price tag because such funding is more expensive than direct Treasury borrowing.

As the committee that pays the bills, the House Ways and Means Committee has a vital stake in assuring resolution of the FSLIC problem at minimum cost and in prompt assessment by the Treasury Department of the federal government's other contingent liabilities that presently may be hidden from view.

Thank you.

APPENDIX A

The Government's Implicit Guarantee of Enterprise Obligations

Government sponsored enterprises rely upon a form of federal credit support familiar to the House Ways and Means Committee because of its responsibility for the public debt and the federal agency credit market. Enterprises are huge financial institutions. Fannie Mae and Freddie Mac each fund or guarantee nearly $300 billion of loans. Sallie Mae, one of the smaller enterprises, had assets of almost $29 billion at year-end 1988, and reported an increase in size of 25 percent for the year.

Thrifts use federal deposit insurance to obtain their federal credit support, at least for depositor accounts up to $100,000. Enterprises use a different device that gives them even greater backing: Their obligations have the attributes of federal Treasury obligations and their guaranteed securities have the attributes of government-backed securities such as are guaranteed by the Government National Mortgage Association, a part of the U.S. Department of Housing and Urban Development. Even though enterprises are owned by private shareholders and controlled by private managers, the obligations have governmental attributes and trade in the federal credit agency market at favorable rates of interest close to those of the U.S. government.

Like U.S. Treasury obligations, enterprise obligations, with some variations, have the following characteristics:

- They may be issued only upon approval of the Secretary of the Treasury, who also approves terms such as interest rate and maturities;
- They are exempt from regulation by the SEC except to the extent the U.S. government securities are regulated;
- They are lawful investments for federally supervised institutions, including banks, thrift institutions, and credit unions and have favorable government-type status in the portfolios of these institutions. (For example, shorter-term enterprise obligations may be used to meet liquidity requirements of thrift institutions, and national banks may invest and deal in enterprise obligations without limit);
- They are lawful investments for federal fiduciary, trust and public funds;
- They are issuable and payable through the facilities of the Federal Reserve Banks;
- They are eligible collateral for Federal Reserve advances and discounts and are eligible to be bought and sold in Federal Reserve open market operations; and

- For most enterprises, they are exempt from state and local taxation.

The one big difference between enterprise securities and U.S. Treasury obligations is that enterprises are privately owned and are not part of the federal government. To strengthen the perception of governmental backing, the enterprises have additional characteristics:

- They are federally chartered instrumentalities of the United States;
- They have a direct or indirect line of credit with the U.S. Treasury; and
- They are controlled by boards that include some governmentally-appointed directors.

Taken together, these attributes amount to an implicit federal guarantee that enterprises will not be allowed to default on their obligations. The federal government makes a strong statement to investors by conferring on enterprise securities the same preferred investment status as U.S. Treasury obligations. The exemption from the usual SEC registration laws removes investor protections considered necessary for all but the most secure (i.e., federally-backed securities). Similarly, the exemption from investment restrictions on banks and thrift institutions is otherwise limited to federally-backed securities. Investors perceive that the government would not permit these exemptions from basic investor protection unless enterprise securities were extremely safe.

This means that investors look primarily to the implicit federal backing as a guarantee of an enterprise's creditworthiness, rather than looking towards its balance sheet. Thus, while borrowing costs did rise somewhat for the Farm Credit System, even after that enterprise recorded $4.6 billion of losses in 1985 and 1986, Farm Credit System securities remained eligible investments for AAA-rated debt.

Over time, the market can become even more confident about the government's likelihood of backing obligations of government sponsored enterprises. As the value of outstanding enterprise obligations increases, so does the inability of the federal government to intimate that it would not stand behind this debt.

When the Continental Illinois Bank failed, for example, the federal government stood not only behind FDIC-insured deposits, but also protected uninsured bank creditors, and even creditors of parent holding company. The Comptroller of the Currency told Congress of fears of a domestic and possible an international financial crisis if all Continental creditors were not protected. The Comptroller of the Currency concluded that because of their size alone, the federal government cannot permit the failure of any of the nation's largest money center banks, many of which are significantly smaller than government sponsored enterprises. Continental Illinois was the nation's sixth largest bank. It had assets of approximately $40 billion, and was significantly smaller than were Fannie Mae, the Federal Home Loan Bank System, or the Farm Credit System.

Because the federal backing for enterprise obligations is implicit rather than express, the market tends to require a slightly higher return on enterprise obligations, than from direct Treasury debt. Treasury obligations compete with enterprise obligations in the same federal agency credit market and the higher yielding enterprise securities in turn increase the cost of Treasury borrowing. As the enterprises continue to grow in size, the impact on Treasury borrowing costs can be expected to increase accordingly.

In summary then, the federal backing of enterprise obligations may be implicit, but it is very real. As in the case of the Farm Credit System, taxpayers have literally billions of dollars at stake if an enterprise fails to meet its obligations.

Chairman ROSTENKOWSKI. Thank you, Mr. Stanton.
Mr. Ely.

STATEMENT OF BERT ELY, PRESIDENT, ELY & CO., INC., ALEXANDRIA, VA

Mr. ELY. Mr. Chairman and members of the committee, I appreciate the opportunity to be here today to discuss the RefCorp situation specifically.

In my opinion, there are three reasons why RefCorp should be funded with on-budget borrowings. One, to save interest costs; two, to more easily provide the additional funds that will be needed for the cleanup beyond the funds the President has requested; and, three, to provide funds more quickly, which is essential in order to minimize the ultimate cost of the FSLIC debacle.

After addressing these reasons, I will then touch on the Gramm-Rudman impact of on-budget financing.

I will now walk you through my prepared statement as I summarize it for you.

There are six reasons to use on-budget financing. First, on-budget financing will reduce interest outlays for two reasons. On-budget financing will eliminate any interest rate premium that will be associated with off-budget financing. And more significantly, on-budget financing will provide greater flexibility in setting the maturity of the debt sold to pay for FSLIC's losses.

This maturity flexibility is important in order to buy time until long-term interest rates have declined from their present levels.

Turning to page 2 of my statement, the amounts that can be saved with on-budget financing are enormous. As you know, an average interest rate spread of 25 basis points on $50 billion of 30-year RefCorp bonds would cause $4.5 billion of additional interest outlays over a 30-year period. Even greater interest rate savings are possible if short-term, on-budget borrowings are rolled over periodically while waiting for long-term rates to drop.

Based on the administration's interest rate assumptions, $49.7 billion in interest outlays can be saved over 30 years if the FSLIC cleanup costs are funded initially with 1-year Treasury bills.

The administration's interest rate assumptions are far too optimistic. However, even a lesser decline in interest rates over the next few years will still yield substantial interest rate savings.

Under more realistic assumptions, the savings in interest outlays with direct Treasury borrowings would be $20.5 billion. The present value of these savings is $7.4 billion. This amount is four times what could be saved by merely selling 30-year Treasury bonds immediately rather than 30-year RefCorp bonds.

This raises the fundamental contradiction in the FSLIC bailout legislation. If one accepts the administration's interest rate assumptions, and the net budget outlays based on these assumptions, then the administration should accept the argument that additional moneys can be saved by initially funding the FSLIC bailout with short-term financing. If one argues, instead, that the bailout should be funded immediately with 30-year bonds, because long-term interest rates are likely to rise, then one must be willing to accept the fact that the net annual budget outlays to fund the FSLIC

cleanup will be substantially higher than the administration has predicted.

Turning to the top of page 3 of my statement, the actual use of bond proceeds argues for using short-term debt for initially funding the FSLIC bailout. Most of the money spent on future FSLIC case resolutions will directly or indirectly shrink the very short-term deposits of insolvent thrifts. Thus, the interest rate yield curve will be distorted far less if $50 billion of short-term Government debt is used to liquidate a like amount of short-term thrift deposits.

Turning to the bottom of page 3 of my statement, a key element of the RefCorp financing structure is being able to purchase already stripped Treasury bonds, or purchasing unstripped Treasuries and then stripping them to defease the RefCorp bonds. The ability of RefCorp to buy sufficient zeroes to defease $50 billion of RefCorp bonds has not been examined closely enough, nor have the debt market consequences of this defeasing process been explored adequately. My written statement explores this issue in great detail.

Turning to page 5 of my statement, the authority for FICO to issue $4 billion more of bonds should be canceled immediately. While it is wasteful to issue RefCorp bonds, it is even more wasteful to continue issuing FICO bonds which carry a higher interest rate than the RefCorp bonds probably will carry.

The FIRREA legislation, as it now stands, clearly does not authorize sufficient outlays to clean up the FSLIC mess. Thus, Congress eventually will have to provide additional monies to complete the FSLIC cleanup. Given that RefCorp debt is more expensive than direct Treasury debt, authorizing additional RefCorp debt will merely increase the magnitude of the unnecessary interest expense of selling even $50 billion of RefCorp bonds.

Instead of starting off with $50 billion of RefCorp financing and then switching to direct Treasury debt when additional billions are needed for the FSLIC cleanup, why not start off on the right foot by selling direct Treasury debt? My written statement discusses why $50 billion of RefCorp bonds will be very inadequate.

Turning to the bottom of page 6 of my statement, one of the major shortcomings of the FSLIC legislation is that it does not provide cash fast enough to deal with currently insolvent thrifts. The key to holding down the cost of the FSLIC cleanup is pumping substantial sums of Federal money into the insolvent thrifts so they can reduce the deposits on which they are paying excessive interest rates. In order to minimize the yield curve impact of raising and dispersing as much as $50 billion of cash by the end of 1989, which I think is going to be needed, this money needs to be raised with short-term direct Treasury debt. RefCorp simply would not be able to raise this amount of cash in a short amount of time.

Concluding, starting at the bottom of page 8 of my statement, raising and spending more cash up front to accelerate the cleanup of the FSLIC mess certainly will cause Gramm-Rudman problems. However, Congress should not flinch in legislating an exception to Gramm-Rudman for the purpose of funding a rapid cleanup of the FSLIC mess.

Although the hour is late, it is not too late for Congress to put the expense of the FSLIC debacle completely on-budget. Certainly

the sentiment in Congress is strong to do so. The 11-to-10 vote in the Senate Banking Committee last week rejecting on-budget financing for the FSLIC cleanup is a measure of the strength of that sentiment.

I urge the Ways and Means Committee to take the lead in putting the FSLIC cleanup on budget. Richard Darman's threat to spread the impact of an on-budget treatment over fiscal years 1989 and 1990 should be dealt with by providing in an exemption to Gramm-Rudman that the budget impact of the FSLIC funding shall lie outside of Gramm-Rudman regardless of the year in which it occurs.

Thank you for your time and consideration of my testimony.

[The statement of Mr. Ely follows:]

TESTIMONY BY BERT ELY
ELY & COMPANY, INC.

I - INTRODUCTION

Mr. Chairman and members of the committee, I am testifying today regarding the feasibility and desirability of funding the accumulated and prospective losses of the Federal Savings and Loan Insurance Corporation (FSLIC) with "off-budget or "on-budget" borrowing. Although both the House and the Senate banking committees have supported the Administration's position that the FSLIC cleanup should be supported with off-budget borrowing, it still is not too late for the Congress to require on-budget financing.

In my opinion, there are three reasons why the FSLIC cleanup should be funded with on-budget borrowings: to save interest costs, to more easily provide the additional funds that will be needed for the cleanup beyond the funds the President has requested, and to provide funds more quickly, which is essential in order to minimize the ultimate cost of the FSLIC debacle. After addressing these reasons, I will conclude by examining the Gramm-Rudman impact of on-budget financing.

II - USE ON-BUDGET FINANCING TO REDUCE INTEREST COSTS

There are five reasons why on-budget financing should be used to fund the FSLIC cleanup operation.

Reason One: On-budget financing can reduce interest outlays. Substantial interest savings are possible with on-budget financing for two reasons. First, on-budget financing would eliminate any interest rate premium that will be associated with off-budget financing. The Administration has estimated that the $50 billion of 30-year bonds to be issued by the Resolution Funding Corporation (REFCORP) will carry an average interest rate spread over 30-year Treasury bonds of .25% (25 basis points). This is a reasonable estimate, although I think that the spread over Treasury bonds on the initial issues of REFCORP bonds will be 35-40 basis points. As the amount of REFCORP bonds outstanding grows, I would expect this spread to decline to 15 basis points.

Second, and much more significantly, on-budget financing would provide greater flexibility in setting the maturity of the debt sold to pay for FSLIC's losses. This maturity flexibility is important in order to buy time until long-term interest rates have declined from their present levels. The Administration proposes selling 30-year REFCORP bonds during the 1989-91 fiscal years. However, this financing strategy makes sense only if one believes that long-term interest rates are at or near their low point. Clearly, the Administration does not believe this, as it has forecast that the rate on 30-year Treasury bonds will decline from the present level of approximately 9.1% to 4% by 1994. Thus, billions of dollars can be saved if the FSLIC cleanup is funded for a few years with short-term borrowings until long-term rates do decline.

The massive amount of existing Treasury debt has created a secondary market with tremendous depth into which additional short-term Treasury debt can be sold. As of March 31, 1989, outstanding Treasury bills with an initial maturity of one year or less totaled $417 billion. An additional $1.12 trillion of Treasury notes, with an initial maturity of one to ten years, also was outstanding on that date. On the other hand, selling short-term REFCORP debt while waiting for long-term interest rates to decline would require creating a new and separate secondary debt market. Due to reduced liquidity in a separate market for REFCORP debt, short-term REFCORP borrowings would carry a higher yield than Treasury bills and notes. Thus, utilizing short-term Treasury borrowings while waiting for long-term rates to drop would provide a funding flexibility lacking in the Administration's plan for bailing out FSLIC.

Potential interest savings. The amounts that can be saved with on-budget financing are enormous. First, an average interest rate spread of 25 basis points on $50 billion of 30-year REFCORP bonds will cause $4.5 billion of additional interest outlays over a 30-year period. The present value or discounted value of this additional $4.5 billion in interest outlays is $1.85 billion. This is an incredible price to pay for budgetary window dressing! Is this dubious evasion of Gramm-Rudman worth $1.85 billion? I hardly think so. Clearly, any interest premium over the rate on direct Treasury debt is without question a waste of taxpayer money.

Second, even greater interest rate savings are possible if short-term, on-budget borrowings are rolled over or refinanced periodically while waiting for long-term rates to drop. Exhibit 1 to this testimony demonstrates how, based on the Administration's interest rate assumptions, $49.7 billion in interest outlays can be saved over thirty years if the FSLIC cleanup costs are funded initially with one-year Treasury bills that are rolled over annually until 1994, when they would be replaced with long-term Treasury bonds. The present value of these interest savings is $19.1 billion! This is more than ten times as much as can be saved by simply selling $50 billion of Treasury bonds in lieu of a like amount of REFCORP bonds. This factor of ten clearly illustrates the potential savings that can be obtained by holding off the long-term financing of the FSLIC cleanup until long-term interest rates have dropped.

The Administration's interest rate assumptions are far too optimistic, but even a lesser decline in interest rates over the next few years will still yield substantial interest rates savings. Exhibit 2 sets out one such interest rate scenario under which the rate on one-year Treasury bills would decline to 6% in fiscal year 1993 and the rate on 30-year Treasury bonds would drop to 7.3% by fiscal year 1994. By comparison, one can reasonably infer from various Administration projections that it has projected a 3 9% rate on one-year Treasuries in 1993 and a 4% rate in 1994 on 30-year Treasuries.

Under the more realistic assumptions utilized in Exhibit 2, the savings in interest outlays with direct Treasury borrowings, compared with REFCORP bonds, would be $20.5 billion. The present value of these savings is $7.4 billion. This amount is four times what could be saved by merely selling 30-year Treasury bonds immediately rather than 30-year REFCORP bonds.

Reason Two: Fundamental contradictions in financing the FSLIC cleanup. The more realistic assumptions of Exhibit 2 lead to a very important consequence when estimating the cost of the FSLIC cleanup that will be borne by the American taxpayer: the effect of a lesser decline in interest rates than predicted by the Administration adds $20.5 billion to net budget outlays for the FSLIC plan over the next ten fiscal years. This raises a fundamental contradiction in the FSLIC bailout legislation that Congress has not adequately addressed: If one accepts the Administration's interest rate assumptions and the net budget outlays based on those assumptions, then the Administration should accept the argument that additional monies can be saved by initially funding the FSLIC bailout with short-term financing. If one argues instead that the bailout should be funded immediately with 30-year bonds because long-term interest rates are likely to rise, then one must be willing to accept the fact that net annual budget outlays to fund the FSLIC cleanup will be substantially higher than the Administration has predicted.

A comparison of Exhibits 1 and 2 will reveal a coincidental, yet meaningful fact. The annual interest outlay of $3.713 billion on REFCORP bonds, as projected by the Administration (Exhibit 1, Alternative A), is almost the same as the annual interest outlay of $3,723 billion projected after year 3 on long-term Treasury bonds (Exhibit 2, Alternative B). What this near equality in dollar amounts shows is that funding the FSLIC cleanup with short-term Treasury bills until long-term Treasury bond rates decline somewhat will completely offset the excessive optimism reflected in the Administration's interest rate assumptions.

Reason Three: Yield curve considerations. There are two aspects of the interest rate yield curve that should be considered when examining the on-budget/off-budget issue. First, while the present inverted yield curve (short-term interest rates are higher than long-term rates) might suggest that it would be cheaper to sell long-term debt at this time, history suggests that the inverted yield curve will disappear within the next twelve to eighteen months as the overall level of interest rates declines. Thus, it is worthwhile to pay a few more millions of dollars in interest cost over the short-term in order to save billions of dollars over the long term. The cost of riding through the inverted yield curve really is relatively small. For example, if an average of $15 billion in FSLIC-related debt is outstanding over fifteen months of an inverted yield curve and if one-year Treasury bills yield on average 20 basis points more than 30-year Treasuries, then the total interest cost for waiting until the yield curve returns to its normal positive slope is approximately $120 million, spread over two or three fiscal years.

Second, interest rate comparisons during the present inverted yield curve should be between the rates on short-term Treasury bills and the projected rate on thirty-year REFCORP bonds. Although the initial spread of the proposed REFCORP bonds over 30-year Treasury bonds probably will be in the range of 35-40 basis points, there have been many days recently when the rate on one-year Treasuries has been equal to or lower than what the likely yield would have been on the REFCORP bonds. This differential largely undercuts the impact of the current inverted yield curve in using direct, short-term Treasury debt to initially fund the FSLIC cleanup.

Third, the actual use of bond proceeds argues for initially funding the FSLIC bailout with short-term debt. Most of the monies spent on future FSLIC case resolutions will directly or indirectly shrink the very short-term deposits of the insolvent thrifts dealt with in the FSLIC cleanup process. In effect, REFCORP is borrowing long to lend short. Thus, if $50 billion of short-term government debt is used to liquidate a like amount of short-term thrift deposits, the interest rate yield curve would be distorted much less, if at all, than would be the case if $50 billion of 30-year Treasury bonds are sold to retire short-term thrift deposits. Certainly a $50 billion shift of funding from short-term debt to long-term debt will not have an inconsequential effect on the yield curve.

I will explain this point in more detail. The cash raised through the sale of Treasury or REFCORP debt will directly shrink thrift deposits when this cash is used to pay off depositors in liquidated thrifts. Indirectly, this cash will shrink thrift deposits when it is paid to acquirers of insolvent thrifts who in turn will use the cash to liquidate over time those deposits that carry above-market interest rates. This type of deposit shrinkage already has occurred in many of the thrifts dealt with last year by FSLIC; however, the new owners of these thrifts are borrowing money for deposit shrinkage purposes from the federal home loan banks since FSLIC had no cash to give to these acquirers.

Some data for all FSLIC-insured thrifts will illustrate the short-term nature of thrift deposits. At the end of 1988, 26% of all thrift deposits were in passbook and checkable accounts; 22% of all deposits were in fixed-rate certificates of deposits (CDs) with an original maturity of six months or less; 19% of all deposits were in CDs with an original maturity of six months to one year; 20% of all deposits were in CDs with an original maturity of one to three years; and 12% of all deposits were in CDs with an original maturity of more than three years or CDs of varying maturity and a variable interest rate. Insolvent thrifts generally have an even shorter-term deposit maturity structure than healthy thrifts.

Reason Four: Potential problems in defeasing the REFCORP bonds. The FSLIC legislation (Financial Institutions Reform, Recovery and Enforcement Act of 1989, or "FIRRE Act") calls for defeasing the $50 billion of REFCORP bonds to be issued under the FIRRE Act with zero-coupon bonds. This means that zero-coupon bonds (which pay no

interest over their life) with a face value of $50 billion will be purchased as the REFCORP bonds are sold to the general public. These zero-coupon bonds, most likely the principal portion of "stripped" 30-year Treasury bonds, would then be placed in a trust. When the stripped Treasuries mature, their proceeds would then be used to retire REFCORP bonds with a like amount of face value.

Thus, a key element of the REFCORP financing structure is being able to purchase already stripped Treasury bonds or alternatively purchasing unstripped Treasuries and then stripping the principal portion to use in defeasing the REFCORP bonds. The ability of REFCORP to buy sufficient stripped zeros to defease $50 billion of REFCORP bonds has not been examined closely enough nor have the debt market consequences of this defeasing process been carefully considered.

There is a relatively limited supply of 30-year Treasury bonds to strip. Over the last three years, the Treasury Department has issued $97.25 billion of 30-year Treasuries. As of the end of last month, $37.31 billion, or 38.4%, of these Treasuries had been stripped. Over $6 billion of the principal portion or zero-coupon Treasury bonds created in this stripping process have been purchased by FICO (the Financing Corporation established by the Competitive Equality Banking Act of 1987 to mortgage FSLIC's future premium income) to defease the principal portion of $6.98 billion of bonds FICO had sold as of March 31, 1989. Approximately 10% of the FICO bonds have been defeased with interest strips created when long-term Treasuries are stripped.

Over the next three years, when the REFCORP bonds are to be issued, approximately $45 billion of 30-year Treasury bonds would have to be stripped to defease a like amount of REFCORP bonds. The balance of the defeasement needs presumably could be met by interest strips with maturities close to the maturity date of the REFCORP bonds, as has been done in defeasing the FICO bonds. The 30-year Treasury bonds that need to be stripped to defease REFCORP bonds could consume one-third to one-half of the 30-year bonds that Treasury will issue over the next three years. The stripping needed for the REFCORP bonds will come in on top of other stripping needs that exist in the Treasury debt market.

The REFCORP bonds will not disappear into a black hole. Rather they will be sold to many of the same investors who now purchase 30-year Treasury debt in either whole or stripped form. The overall effect of selling REFCORP bonds, however, will be to increase the aggregate amount of long-term government and quasi-government debt held by investors. All other things being equal, increasing the total supply of long-term debt will drive up the interest rate on this debt. This reflects the consequence cited above of using long-term government-issued debt to liquidate short-term thrift deposits. It is difficult to estimate the magnitude of the upward shift in the rate on Treasury debt issued over the next few years. However, this impact will spread to other long-term debt issues, most notably to fixed-rate 30-year home mortgages as well as to the longer-term tranches of mortgage-backed securities.

REFCORP bonds presumably will be stripped just as recent FICO bond issues have been stripped. Supposedly, the stripped REFCORP zero-coupon bonds will be perfect substitutes for the Treasury zero-coupon bonds defeasing the REFCORP zero-coupon bonds. But, fragmenting the demand for zero-coupon bonds between Treasury zeros, REFCORP zeros, and FICO zeros has to impair the liquidity of each market. This fragmentation effect most likely will boost the yields on REFCORP and FICO bonds. Rates on direct Treasury debt issues probably will decline somewhat because of a reduced supply of unstripped 30-year Treasury bonds. That may seem like a great deal for the Treasury; however, the interest savings on the Treasury debt most likely will be less than the additional interest expense on the REFCORP and FICO bonds. Thus, the total cost of the FSLIC cleanup borne by the taxpayer will be higher than it would be if straight Treasury debt were used to finance the cleanup. The same interest cost effect probably will occur with the interest strip portions of long-term Treasury, REFCORP, and FICO bonds.

One way the Treasury Department could lessen the impact of the REFCORP bond issuance on the demand for stripped Treasuries would be to issue 30-year zero-coupon Treasury bonds directly to REFCORP. However, selling special 30-year zero-coupon Treasury bonds directly to REFCORP most likely would add $50 billion to the national debt, since these bonds would have a face or par value of $50 billion.

Reason Five: Continued issuance of FICO bonds also will add unnecessary costs to the FSLIC cleanup. As of today, FICO has issued $6.98 billion in bonds. Thus, it can issue another $3.845 billion of bonds under its initial borrowing authority of $10.825 billion. This authority should be canceled immediately as these bonds, which most recently have yielded about 50 basis points over direct Treasury debt when issued, represent more costly debt than REFCORP bonds. Presumably the FICO bonds carry a higher yield because the Treasury is not a backstop behind the interest paid on the FICO bonds while monies will be appropriated if necessary to pay interest on REFCORP bonds. In effect, while it is wasteful to issue REFCORP bonds, it is even more wasteful to continue issuing FICO bonds. It is interesting to note that Treasury, in the technical amendments it submitted to the FIRRE legislation, requested that the annual issuance limit on FICO bonds be removed so that the remaining bonds could be sold as quickly as possible. That amendment should be replaced by one barring the issuance of any more FICO bonds.

III - ON-BUDGET FINANCING WILL BE NEEDED TO FUND EXTRA FSLIC OUTLAYS

The FIRRE legislation as it now stands clearly does not authorize sufficient outlays to clean up the FSLIC mess. Thus, Congress eventually will have to appropriate or otherwise provide additional monies to complete the FSLIC cleanup. Given the almost certain assumption that the federal government will continue to operate with budget deficits for at least another five years, additional monies for the FSLIC cleanup can be provided in one of two ways: issuing direct Treasury debt or authorizing the sale of additional REFCORP bonds. Given that REFCORP debt will be more expensive than direct Treasury debt, authorizing additional REFCORP debt will merely increase the magnitude of the already unnecessary interest expense of selling even $50 billion of REFCORP bonds. Instead of starting off with $50 billion of REFCORP financing and then switching to direct Treasury debt when additional tens of billions of dollars are needed for the FSLIC cleanup, why not start off on the right foot by selling direct Treasury debt?

Why $50 billion of REFCORP bonds will not be sufficient. The $50 billion to be raised through the sale of REFCORP bonds is just part of an overall financing program for funding the FSLIC cleanup. As shown in the cash flow summary of Exhibit 3, the Administration anticipates spending $153 billion through fiscal year 1999 in cleaning up the FSLIC mess. REFCORP bond proceeds would cover almost one-third of this spending. However, based on these cash flows and the Administration's interest rate assumptions that underlie them, this spending program will cover only $69 billion of FSLIC's accumulated losses, measured on a present value basis. While estimates of FSLIC's losses vary greatly, most estimates of the present value cost of cleaning up the FSLIC mess range from $80 billion to $120 billion.

My own loss estimates are in that range. In particular, I believe the present value cost of dealing with FSLIC cash resolutions through the end of 1988 plus the eventual cost of disposing of the 600 or so insolvent thrifts still in business could hit $120 billion if the more egregious of last year's case resolutions are not renegotiated. FSLIC has estimated that last year's case resolutions had a present-value cost of $38 billion. However, as a recent Mid-America Institute report commissioned by the Federal Home Loan Bank Board has stated, many of last year's deals contain perverse incentives in their assistance agreements that will cause the acquirers in these transactions to maximize FSLIC's losses. Unless these deals are renegotiated, their present value cost to FSLIC could easily rise to $50 or $60 billion. The prolonged cleanup of the FSLIC mess envisioned by the Administration also will add unnecessary billions of dollars to the FSLIC cleanup cost.

Exhibit 4 demonstrates that net budget outlays will increase by $21.6 billion over what the Administration has projected simply if one uses more realistic interest rate and deposit growth assumptions for the next ten years. This amount is the difference between the $40 billion in net budget outlays underlined in the cash flow summary of Exhibit 3 and the $61.6 billion amount underlined in Exhibit 4.

Interestingly, the present value of the FSLIC problems that can be resolved under the scenarios presented in Exhibits 3 and 4 is almost identical: about $69 billion. Add in the additional cash outlays needed to solve a $100 or $120 billion problem and the financing needs not covered by the Administration's projected net budget outlays of $40 billion could easily rise from $50 billion to $100 billion or $125 billion. Funding an additional $50-$75 billion of outlays with 30-year bonds would further distort the interest yield curve, as discussed above. Thus, faced with the almost certain need for outlays far in excess of what the Administration has forecast, the Congress should correct the error of the Administration's ways and authorize direct, short-term debt to fund the FSLIC cleanup.

Two more points merit mentioning. One, only $40 billion of the $50 billion to be raised from the sale of REFCORP bonds actually will be used to pay for the FSLIC cleanup. As shown on line 35 of both Exhibits 3 and 4, the Administration anticipates that $10 billion of the $50 billion expended in dealing with post-1988 case resolutions will be recovered from asset liquidations or receivership collections. This $10 billion will not be spent on additional case resolution activity. Instead, this $10 billion will be used to pay a portion of the REFCORP bond interest, as the Administration's own cash flow projections very clearly show. This practice of borrowing a portion of the interest to be paid is substantially the same practice developers used when they borrowed sufficient monies from Texas S&Ls to not only cover all development costs, but also the first three or four years of interest on the loan.

Two, the FSLIC loss estimates I discussed above do not take into account the substantial insolvency losses that will occur in the 1990s among federally insured thrifts as a result of the very liberal capital forbearance rules that are likely to be incorporated in the FIRRE Act. The taxpayer ultimately will be on the hook for these additional losses; Congress should at least try to minimize them by financing these losses with direct Treasury debt rather than off-budget gimmickry.

IV - THE FSLIC CLEANUP EFFORT NEEDS MONEY FASTER

One of the major shortcomings of the FIRRE Act is that it does not provide cash fast enough to deal with currently insolvent thrifts. Key to holding down the cost of the FSLIC cleanup is pumping substantial sums of federal money into the insolvent thrifts so that they can reduce the deposits on which they are paying excessive interest rates. In order to minimize the yield curve impact of raising and dispersing as much as $50 billion of cash by the end of 1989, this money needs to be raised with short-term direct Treasury debt. REFCORP simply could not raise this amount of cash in a short period of time. Using federal monies to rapidly liquidate the above-market-interest-rate deposits of every insolvent thrift also would shrink these thrifts to a more manageable size, thus making it easier to dispose of them. These outlays would not be wasted monies; rather they would represent a major down payment on cleaning up the FSLIC mess.

As shown on lines 33 and 34 of Exhibit 3, the Administration has proposed spending $10 billion this fiscal year in disposing of insolvent thrifts, $25 billion in fiscal year 1990, and $15 billion in fiscal year 1991. These funds would be spent in equal amounts in assisted mergers and liquidations. Given the delay in enacting the FIRRE, this spending schedule will slip by at least three months (This is an assumption underlying Exhibits 1 and 2).

The Administration's proposed spending schedule has been dictated to a great extent by the speed with which it can sell the REFCORP bonds without excessively disturbing the long-term debt markets. As a consequence, though, the Administration will only be able to deal with a few insolvent thrifts at a time. This means that most of the insolvent thrifts now being placed in the FDIC conservatorship program will remain in conservatorship for a year or two until they can be acted upon by the Resolution Trust Corporation (RTC) created by the FIRRE Act. While these insolvent thrifts sit in conservatorship, they will have to continue attracting new deposits with above-market interest rates in order to pay their bills and thus keep their doors open.

The need for insolvent thrifts to pay above-market interest rates will continue to drive up deposit interest rates for all banks and thrifts, thus distorting interest rates and harming our healthy banks and thrifts. The unnecessarily high deposit rates paid by the insolvent thrifts also add to the eventual cost of disposing of these thrifts. All of this additional cost will be paid by the taxpayer. In a sense, deposits in the insolvent thrifts equal in amount to their real negative net worths represent backdoor federal borrowing at interest rates that often are above the rate of direct Treasury borrowings of a comparable maturity.

Two additional factors justify a rapid deposit shrinkage of all the insolvent thrifts. One, the interest rate premium insolvent thrifts pay, i.e. the difference between the above-market rate they pay and a market interest rate, represents an unintended yet substantial wealth transfer to the depositors receiving the interest rate premium. That wealth transfer, which I estimate could be as much as $2 billion annually, ultimately will be paid by the American taxpayer. Most likely, this wealth transfer is mildly regressive in that the economic demographics of the recipients of this interest rate premium probably are above the economic demographics of the taxpaying population.

Two, an insolvent thrift bloated in size by above-market-interest-rate deposits will be more difficult to sell than will be the case if the thrift is shorn of these deposits. The larger an insolvent thrift is, the more capital an acquirer will have to invest in it and thus the smaller the pool of potential buyers for the institution. More importantly, the presence of above-market-rate deposits will mask the true size and prospects of an insolvent thrift. The resulting uncertainty will scare away some prospective buyers and cause others to ask for more federal assistance to take over the thrift than would be the case if the above-market-rate deposits had been melted away. Thus, the disposal of insolvent thrifts will be greatly enhanced if their above-market-rate deposits are first liquidated with federal cash.

Deposit shrinkage can be accomplished quickly and easily. Deposit shrinkage in insolvent thrifts can easily and rapidly be accomplished across-the-board within the context of the FDIC conservatorship program for these thrifts. The conservator in each insolvent thrift would simply and immediately cut the deposit offering rates of the thrift to levels competitively established in the insolvent thrift's local market by competing solvent banks and thrifts. In effect, the insolvent thrifts no longer would compete for deposits; instead, they would passively follow the rates established by solvent institutions. This program would not represent a return of Regulation Q interest rate controls because the solvent banks and thrifts would retain complete freedom to establish the deposit interest rates they paid.

Cutting deposit interest rates in the insolvent thrifts would stimulate a substantial deposit outflow from these thrifts. Interest-rate-sensitive balances in NOW and money-market-deposit accounts would begin to flow out fairly quickly as depositors shifted these balances to higher yielding investments. Rate-sensitive balances invested in certificates of deposit likewise would flow out of insolvent thrifts as these CDs matured. Most of this deposit outflow would occur within six months after this rate-cutting program was initiated. The amount of outflow is difficult to estimate.

However, a $50 billion outflow is not an unreasonable expectation as this amount equals twenty percent of the $250 billion or more of deposits in the nation's genuinely insolvent thrifts. A substantial portion of these deposits are in thrifts dealt with last year by the FSLIC. In effect, many of last year's case resolutions created or perpetuated thrifts that are still insolvent.

Whatever the amount of the deposit outflow, it would represent a down payment on the eventual cost of disposing of these thrifts. Furthermore, triggering these deposit outflows would permit the RTC to quickly take action to end the distortion on deposit interest rates caused by all of these thrifts. It also would quickly bring an end to the unintended and undesirable wealth transfer now flowing to depositors being paid above-market interest rates.

This deposit outflow would not go into mattresses; instead, it would be reintermediated through other depository institutions and through other intermediation channels. Some of the deposit outflow would be redeposited in local institutions. This would be particularly true for deposits owned by local residents. Much of the deposit outflow would be redeposited in banks and thrifts located where the owners of these deposits live. For example, a resident of Chicago is not likely to leave his money in an insolvent Texas thrift if he can earn the same or nearly the same rate of interest in a nearby bank or thrift. In effect, convenience factors will bring billions of deposits back home.

Much of this deposit outflow will be put back into the financial system through other types of intermediaries. In the present interest rate environment, billions of dollars flowing out of the insolvent thrifts would be used to purchase the very Treasury bills and notes being sold to fund these deposit outflows. Other depositors would place the deposits they pulled out of insolvent thrifts in money market mutual funds, corporate bonds, and insurance products. Eventually, the loop would close and these monies would flow into the Treasury bills and notes sold to fund these deposit outflows. The yield curve impact of this transformation process could be minimized by properly matching the maturity of the federal debt sold to fund the deposit outflow <u>with</u> the maturity of the financial instruments into which the deposit outflow was reinvested. The overall effect of this deposit shrinkage would be to redenominate thrift deposits as short-term Treasury debt.

Overintermediation through banks and thrifts, which developed during the 1980s as the thrift crisis worsened, would be substantially eased to the extent that deposits flowing out of the insolvent thrifts did <u>not</u> flow back into banks and other thrifts. Lessening depository overintermediation is a key element of eliminating the overcapacity among our deposit-taking institutions (banks, thrifts, credit unions, and money market mutual funds) that has been plaguing all banks and thrifts in recent years. This overcapacity is a key reason why the operating costs of our nation's deposit-taking institutions rose from 1.8% of GNP in the late 1970s to 2.7% of GNP in the 1986-88 period.

V - BUDGET IMPACT ISSUES

Raising and spending more cash up front to accelerate the cleanup of the FSLIC mess certainly will cause Gramm-Rudman problems. But the Gramm-Rudman budget constraints are arbitrary and they are evaded with increasing frequency. Thus, it will be necessary for Congress to enact an exception to Gramm-Rudman so that the FSLIC mess can be treated in the most cost-effective manner possible. Congress should not flinch in legislating an exemption from Gramm-Rudman for the purpose of funding a rapid cleanup of the FSLIC mess.

There is a simple, yet powerful rationale for enacting an exemption to the Gramm-Rudman deficit limits for the purpose of accommodating the FSLIC cleanup. Gramm-Rudman is supposed to limit the real economic resources consumed in a given year by the federal government in excess of the revenues collected by the government in that year. Spending federal funds, however, to clean up the FSLIC

mess will not consume any real economic resources. All of that consumption -- the buildings built, the parties held, the airplanes flown, the economic resources wasted -- lies in the past, specifically in the years in which the wasteful activities took place.

Due to the full-faith-and-credit resolutions Congress first adopted in 1982, FSLIC's accumulated insolvency losses effectively have been adding to the overall national debt since 1982. For federal budgetary purposes, however, the FSLIC element of the national debt has not yet been recognized. This lack of recognition is a shortcoming of national budget accounting and nothing more. As a consequence, the annual budget deficit of the federal government has been consistently understated by the amount of increase in FSLIC's accumulated losses. Thus, selling Treasury bonds to generate the cash needed to clean up the FSLIC mess really is nothing more than refunding a portion of the federal debt. Instead of spending money, the federal government would be replacing very expensive federal debt, i.e. the accumulated insolvency losses in FSLIC and in still-operating insolvent thrifts, with much cheaper direct Treasury debt. Since federal debt refundings have no Gramm-Rudman effect, the debt raised for the FSLIC cleanup likewise should have no Gramm-Rudman effect. Exempting FSLIC expenditures would be a unique event. There are no other instances I am aware of where unrecognized liabilities of the federal government require immediate refunding with cheaper debt.

The Treasury Department has expressed concern about how foreign governments and banks would respond to an exemption to Gramm-Rudman to accommodate a quick FSLIC cleanup. I think we have to give bankers and other nations more credit than the expression of that concern gives them. They will be the last to be fooled by any type of off-budget financing for FSLIC; further, I think they would applaud any action that minimizes the cost and eventual budget impact of cleaning up the FSLIC mess.

VI - CONCLUSION

Although the hour is late, it is not too late for Congress to put the expense of the FSLIC debacle on budget. Certainly the sentiment in Congress is strong to do so. The 11-10 vote in the Senate Banking Committee last week rejecting on-budget financing for the FSLIC cleanup is a measure of the strength of that sentiment. I urge the Ways and Means Committee to take the lead in putting the FSLIC cleanup on budget. The threats of OMB Director Richard Darman to spread the impact of an on-budget treatment over fiscal years 1989 and 1990 should be dealt with by providing in an exemption to Gramm-Rudman that the budget impact of the FSLIC funding shall lie outside the Gramm-Rudman calculations regardless of the year in which the FSLIC funding occurs.

Thank you for your time and consideration of my testimony.

An analysis of the proposed financing for the Bush FSLIC Bailout Plan

Interest cost comparison: Treasury's financing proposal for $50 billion of bonds versus rolling over $50 billion of short-term financing until long-term Treasury bond rates drop to 4% in 1994

Dollars in millions

	--------Quarter in which REFCORP bonds or Treasury bills are first sold--------									
	FY 1989 Q4	FY 1990 Q1	FY 1990 Q2	FY 1990 Q3	FY 1990 Q4	FY 1991 Q1	FY 1991 Q2	FY 1991 Q3	FY 1991 Q4	Totals
Part A - Treasury financing proposal:										
REFCORP bonds sold [1]	$5,000	$5,000	$6,250	$6,250	$6,250	$6,250	$5,000	$5,000	$5,000	$50,000
REFCORP interest rate [2]	9.1%	7.9%	7.9%	7.9%	7.9%	6.5%	6.5%	6.5%	6.5%	
Annual interest cost	455	395	494	494	494	406	325	325	325	3,713
Total interest over 30 years	13,650	11,850	14,813	14,813	14,813	12,188	9,750	9,750	9,750	111,375
Discount rate (30-year Treas.) [3]	8.8%	7.6%	7.6%	7.6%	7.6%	6.2%	6.2%	6.2%	6.2%	
Present value of interest paid	4,759	4,620	5,775	5,775	5,775	5,474	4,379	4,379	4,379	45,317
Part B - Alternative financing - 1-year Treasury notes are rolled over annually until 1994; balance of the 30 year period is then funded with 4% Treasury bonds:										
Interest rate assumptions inferred from Administration's forecast [4]:										
1-year Treasury bills issued during FY89	7.1%									
1-year Treasury bills issued during FY90	6.3%									
1-year Treasury bills issued during FY91	5.3%									
1-year Treasury bills issued during FY92	4.6%									
1-year Treasury bills issued during FY93	3.9%									
30-year Treasury bonds issued during FY94	4.0%									
Interest payment cash flows under this alternative:										
Treasury bills sold [5]	$5,000	$5,000	$6,250	$6,250	$6,250	$6,250	$5,000	$5,000	$5,000	$50,000
Total interest over 30 years [6]	6,360	6,205	7,756	7,756	7,756	7,613	6,090	6,090	6,090	61,716
Discount rate (30-year Treas.) [3]	8.8%	7.6%	7.6%	7.6%	7.6%	6.2%	6.2%	6.2%	6.2%	
Present value of interest paid	2,400	2,523	3,153	3,153	3,153	3,473	2,779	2,779	2,779	26,192
Interest paid in year 1	$355	$315	$394	$394	$394	$331	$265	$265	$265	$2,978
Interest paid in year 2	315	265	331	331	331	288	230	230	230	2,551
Interest paid in year 3	265	230	288	288	288	244	195	195	195	2,186
Interest paid in year 4	230	195	244	244	244	250	200	200	200	2,006
Interest paid in year 5	195	200	250	250	250	250	200	200	200	1,995
Interest paid in year 6	200	200	250	250	250	250	200	200	200	2,000
Interest paid in year 7	200	200	250	250	250	250	200	200	200	2,000
Interest paid in each of the years 8 to 30	200	200	250	250	250	250	200	200	200	2,000

$49.7 billion difference in interest outlays (undiscounted)

$19.1 billion difference in the present value of the interest outlays

Footnotes:

[1] REFCORP bonds sold lag by one quarter the schedule set forth in the Administration's cash flow forecast for the FSLIC bailout plan. This lag reflects the likely delay in passing the FSLIC bailout bill.

[2] The interest rate on the REFCORP bonds is the Administration's rate forecast for these bonds.

[3] The discount rate used is the Administration's 30-year bond rate forecast for the quarter in which financing is first raised to pay FSLIC's bills. The 30-year bond rate was selected as the discount rate for both alternatives so as to have a comparable basis for comparing the present value of the two alternatives.

[4] The one-year Treasury bill forecast was derived from the Administration's cash flow forecast for the FSLIC bailout plan and the interest rate assumptions set forth in the budget for fiscal year 1990.

[5] Assumes the same financing schedule as the Treasury's financing plan except that funds initially would be raised by selling one-year Treasury bills instead of long-term REFCORP bonds.

[6] The amounts on this line are the sum of the annual interest amounts shown below in the same column.

Exhibit 1

An analysis of the proposed financing for the Bush FSLIC Bailout Plan based on a more realistic interest rate forecast

Interest cost comparison: Treasury's financing schedule for $50 billion of bonds versus rolling over $50 billion of short-term financing until long-term Treasury bond rates drop from their present levels

Dollars in millions

	--------Quarter in which REFCORP bonds or Treasury bills are first sold--------									
	FY 1989 Q4	FY 1990 Q1	FY 1990 Q2	FY 1990 Q3	FY 1990 Q4	FY 1991 Q1	FY 1991 Q2	FY 1991 Q3	FY 1991 Q4	Totals
Part A - Treasury financing schedule:										
REFCORP bonds sold [1]	$5,000	$5,000	$6,250	$6,250	$6,250	$6,250	$5,000	$5,000	$5,000	$50,000
REFCORP interest rate [2]	9.6%	9.4%	9.2%	9.0%	8.8%	8.6%	8.4%	8.3%	8.2%	
Annual interest cost	470	468	572	559	547	534	418	413	408	4,395
Total interest over 30 years	14,325	14,025	17,156	16,781	16,406	16,031	12,525	12,375	12,225	131,850
Discount rate (L-T Treasury) [3]	9.2%	9.0%	8.9%	8.7%	8.5%	8.3%	8.2%	8.1%	8.0%	
Present value of interest paid	4,820	4,803	5,928	5,903	5,877	5,850	4,613	4,600	4,588	46,981
Part B - Alternative financing - 1-year Treasury notes are rolled over annually for three years; the balance of the 30 year period is then funded with long-term Treasury bonds:										
Interest rate assumptions: [4]										
1-year Treasury bills issued during FY89	9.1%									
1-year Treasury bills issued during FY90	8.6%									
1-year Treasury bills issued during FY91	7.4%									
1-year Treasury bills issued during FY92	6.5%									
1-year Treasury bills issued during FY93	6.0%									
Long-term Treasury bonds issued during FY92	7.8%									
Long-term Treasury bonds issued during FY93	7.5%									
Long-term Treasury bonds issued during FY94	7.3%									
Interest payment cash flows under this alternative:										
Treasury bills sold [5]	$5,000	$5,000	$6,250	$6,250	$6,250	$6,250	$5,000	$5,000	$5,000	$50,000
Total interest over 30 years [6]	11,785	11,250	14,063	14,063	14,063	13,562	10,850	10,850	10,850	111,335
Discount rate (L-T Treasury) [3]	9.2%	9.0%	8.9%	8.7%	8.5%	8.3%	8.2%	8.1%	8.0%	
Present value of interest paid	4,014	3,860	4,868	4,956	5,047	4,894	3,952	3,990	4,028	39,609
Interest paid in year 1	$455	$430	$538	$538	$538	$463	$370	$370	$370	$4,070
Interest paid in year 2	430	370	463	463	463	406	325	325	325	3,569
Interest paid in year 3	370	325	406	406	406	375	300	300	300	3,189
Interest paid in year 4	390	375	469	469	469	456	365	365	365	3,723
Interest paid in year 5	390	375	469	469	469	456	365	365	365	3,723
Interest paid in year 6	390	375	469	469	469	456	365	365	365	3,723
Interest paid in year 7	390	375	469	469	469	456	365	365	365	3,723
Interest paid in each of the years 8 to 30	390	375	469	469	469	456	365	365	365	3,723

$20.5 billion difference in interest outlays (undiscounted)

$7.4 billion difference in the present value of the interest outlays

Footnotes:

[1] REFCORP bonds sold lag by one quarter the schedule set forth in the Administration's cash flow forecast for the FSLIC bailout plan. This lag reflects the likely delay in passing the FSLIC bailout bill.

[2] The interest rate spread on REFCORP bonds over long-term Treasury bonds is assumed to decline from 35 basis points in FY89 to 25 basis points in FY90 and to 15 basis points in FY91.

[3] The discount rate used is the long-term bond rate forecast for the quarter in which financing is first raised to pay FSLIC's bills. The long-term bond rate was selected as the discount rate for both alternatives so as to have a comparable basis for comparing the persent value of the two alternatives.

[4] The interest rate assumptions reflect a more realistic decline in interest rates than the decline forecast by the Administration.

[5] Assumes the same financing schedule as the Treasury's financing plan except that funds would be raised for the first three years by rolling over one-year Treasury bills instead of immediately selling long-term REFCORP bonds.

[6] The amounts on this line are the sum of the annual interest amounts shown below in the same column.

Exhibit 2

Treasury Department's FSLIC forecast -- Fiscal years 1989 to 1999

Line Dollars in billions

No.		FY89	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	Totals: FY 89-99	Present value
	Inferred assumptions in Treasury projection:													
	GNP estimate:													
1	Real GNP growth	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%		
2	GNP deflator (inflation rate)	3.80%	2.85%	1.70%	1.00%	1.00%	1.00%	1.00%	1.00%	1.00%	1.00%	1.00%		
3	Nominal dollar GNP for the fiscal year	5,100	5,398	5,652	5,878	6,113	6,358	6,612	6,877	7,152	7,438	7,735		
	FSLIC-insured deposits:													
4	Annual growth rate	---	7.20%	7.20%	7.20%	7.20%	7.20%	7.20%	7.20%	7.20%	7.20%	7.20%		
5	Average deposits for fiscal year	1,010	1,083	1,161	1,244	1,334	1,430	1,533	1,643	1,761	1,888	2,024		
6	FSLIC premium rate	0.21%	0.21%	0.22%	0.23%	0.23%	0.19%	0.18%	0.18%	0.18%	0.18%	0.18%		
	FDIC-insured deposits:													
7	Annual growth rate	---	6.90%	6.90%	6.90%	6.90%	6.90%	6.90%	6.90%	6.90%	6.90%	6.90%		
8	Average deposits for fiscal year	2,130	2,277	2,434	2,602	2,782	2,974	3,179	3,398	3,632	3,883	4,151		
9	Additional FDIC premium rate	0.000%	0.028%	0.059%	0.067%	0.067%	0.067%	0.067%	0.067%	0.067%	0.067%	0.067%		
10	Ratio: Deposits to nominal GNP	61.6%	62.2%	63.6%	65.4%	67.3%	69.3%	71.3%	73.3%	75.4%	77.6%	79.8%		
	Interest rate assumptions:													
11	Rate on 30-year Treasuries	8.80%	7.60%	6.20%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%		
12	REFCORP bond rate (weighted average)	9.10%	8.43%	7.93%	7.70%	7.70%	7.70%	7.70%	7.70%	7.70%	7.70%	7.70%		
13	FICO bond rate (weighted average)	9.80%	9.65%	9.50%	9.50%	9.50%	9.50%	9.50%	9.50%	9.50%	9.50%	9.50%		
14	Assumed interest rate on FSLIC notes	9.50%	7.80%	6.10%	4.90%	4.30%	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%		
15	- Spread over thrift cost of funds	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%		
16	+ Implied thrift cost of funds	9.00%	7.30%	5.60%	4.40%	3.80%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%		
17	FICO bonds outstanding -- start of fiscal year	3.75	7.50	10.83	10.83	10.83	10.83	10.83	10.83	10.83	10.83	10.83		
18	REFCORP bonds outstanding -- start of fiscal year	0	10	35	50	50	50	50	50	50	50	50		
	FSLIC cash inflows:													
19	FHLB retained and future earnings	0.8	1.1	0.8	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	5.1	
20	S&L premiums	2.1	2.3	2.6	2.9	3.1	2.8	2.8	3.0	3.2	3.4	3.6	31.6	
21	- Secondary Reserve recovery	(0.1)	(0.1)	(0.1)	(0.1)	(0.3)	0.0	0.0	0.0	0.0	0.0	0.0	(0.7)	
22	Sale of FICO bonds	3.75	3.33	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	7.1	
23	Sale of REFCORP bonds	10.0	25.0	15.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	50.0	
24	Total cash inflows	16.6	31.6	18.3	3.1	3.1	3.1	3.1	3.3	3.5	3.7	3.9	93.1	
	FSLIC expenditures (budgetary accounting)													
	Pre-1/1/89 cases:													
25	FSLIC notes issued during FY 89	9.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	9.7	
26	Interest on FSLIC notes ($9.7 bil. initially)	1.6	1.5	1.1	0.9	0.8	0.7	0.7	0.6	0.6	0.6	0.2	9.2	
27	Repay notes issued prior to FY87	0.0	0.0	0.2	0.0	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.5	
28	Assistance agreement payments	5.2	4.4	3.8	4.2	3.4	2.9	1.0	1.0	1.0	1.0	1.0	28.8	17.8

Cash flow summary -- undiscounted basis:

Uses of cash:	
Net outlays on pre-1989 cases	37.7
Net outlays on post-1988 cases	62.0
Interest - FICO and REFCORP bonds	47.2
Purchase of zero-coupon bonds	6.0
Total cash outlays	153.0
Sources of cash:	
Earnings from FHLBs	5.1
Premiums paid by S&Ls	30.9
Bond sales - REFCORP and FICO	57.1
Total cash receipts	93.1
Net FSLIC outlays	(59.9)
- FDIC tax (premium) offset	19.9
Net budget outlay	(40.0)
- Omissions from Treasury projection	(6.2)
Net budget outlay after omissions	(46.3)

Size of problem solved, in present value terms:

FSLIC notes outstanding - 12/31/88	19.2
Assistance agreements O/S - 12/31/88	17.8
Clean up of insolvents at 1-1-89	32.1
Total based on Treasury assumptions	69.1

Exhibit 3 - Page 1

		FY89	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY 89-99	
29	Liquidations - 10/1-12/31/88	1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.0	
30	FSLIC operating expenses	0.3	0.3	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.2	0.2	2.8	
31	- Other old collections (except FICO bonds)	(1.9)	(1.8)	(1.6)	(1.3)	(1.8)	(2.0)	(0.8)	(0.8)	(0.8)	(0.8)	(0.7)	(14.3)	
32	Net outlays - pre-1/1/89 cases	16.0	4.4	3.8	4.1	2.9	1.9	1.1	1.0	1.0	1.0	0.7	37.7	
	Post-1988 resolutions:													
	S&Ls insolvent on 1/1/89 - RTC cases													
33	Assisted mergers	5.0	12.5	7.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	25.0	
34	Liquidations	5.0	12.5	7.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	25.0	
35	- Receivership collections	0.0	(0.5)	(1.8)	(2.5)	(2.5)	(2.0)	(0.8)	0.0	0.0	0.0	0.0	(10.0)	
36	Net spending - RTC cases	10.0	24.5	13.3	(2.5)	(2.5)	(2.0)	(0.8)	0.0	0.0	0.0	0.0	40.0	32.1
37	S&Ls insolvent after 1/1/89 (post-RTX cases)	0.0	0.0	2.0	2.4	3.6	2.0	2.3	2.6	2.8	3.0	3.3	24.0	
38	- Receivership collections	0.0	0.0	0.0	(0.1)	(0.2)	(0.4)	(0.5)	(0.4)	(0.3)	(0.1)	0.0	(2.0)	
39	Net spending - post-RTC cases	0.0	0.0	2.0	2.3	3.4	1.6	1.8	2.2	2.5	2.9	3.3	22.0	
40	Expected losses as a % of deposits			0.17%	0.18%	0.25%	0.11%	0.12%	0.13%	0.14%	0.15%	0.16%		
41	Post-1988 resolution spending - Net	10.0	24.5	15.3	(0.2)	0.9	(0.4)	1.0	2.2	2.5	2.9	3.3	62.0	
	Interest expense:													
42	FICO bonds	0.6	0.9	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	10.7	
43	REFCORP bonds	0.5	1.9	3.4	3.9	3.9	3.9	3.9	3.9	3.9	3.9	3.9	36.5	
44	Total interest expense	1.0	2.8	4.4	4.9	4.9	4.9	4.9	4.9	4.9	4.9	4.9	47.2	
45	REFCORP defeasance (purchase of zeros)	0.8	2.8	2.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	6.0	
46	Total expenditures	27.8	34.4	25.9	8.8	8.6	6.4	7.0	8.1	8.4	8.8	8.8	153.0	
47	Net outlays for FSLIC (budget impact)	(11.2)	(2.8)	(7.6)	(5.7)	(5.5)	(3.3)	(3.9)	(4.8)	(4.9)	(5.1)	(4.9)	(59.9)	
48	- Budget offset effect of additional FDIC tax	0.0	0.6	1.4	1.7	1.9	2.0	2.1	2.3	2.4	2.6	2.8	19.9	
49	Net budget outlay (including additional FDIC tax)	(11.2)	(2.2)	(6.2)	(4.0)	(3.7)	(1.3)	(1.8)	(2.5)	(2.5)	(2.5)	(2.1)	(40.0)	
	Omissions from Treasury projection:													
50	Impact of corporate tax offset of higher DI tax	0.0	(0.2)	(0.5)	(0.6)	(0.7)	(0.5)	(0.5)	(0.6)	(0.6)	(0.6)	(0.7)	(5.6)	
51	Defeasement of new FICO bonds	(0.3)	(0.4)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	(0.7)	
52	Net budget outlay after inclusion of omissions	(11.5)	(2.8)	(6.7)	(4.6)	(3.3)	(1.9)	(2.3)	(3.1)	(3.1)	(3.1)	(2.8)	(46.3)	
53	- Net budget outlay as reported in Treasury proj.	(11.1)	(1.9)	(6.0)	(3.8)	(3.7)	(1.5)	(1.9)	(2.6)	(2.6)	(2.6)	(2.2)	(39.9)	
54	Net increase in outlay from Treasury projection	0.4	0.9	0.7	0.8	0.6	0.4	0.4	0.5	0.5	0.5	0.6	6.4	
55	Memo: Net budget outlay, per 1990 Reagan budget	(8.7)	(2.1)	(6.6)	(4.9)	(4.9)	(3.4)							

FSLIC forecast based on current interest rates -- Fiscal years 1989 to 1999

Dollars in billions

Line No.		FY89	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	Totals: FY 89-99	Present value
	Economic assumptions:													
	GNP estimate:													
1	Real GNP growth	2.25%	1.00%	0.38%	1.00%	2.00%	2.50%	3.30%	5.00%	3.00%	1.00%	1.00%		
2	GNP deflator (inflation rate)	4.50%	3.75%	2.55%	1.72%	1.36%	0.98%	2.50%	4.50%	4.50%	3.50%	2.50%		
3	Nominal dollar GNP for the fiscal year	5,100	5,342	5,499	5,648	5,838	6,041	6,391	6,999	7,523	7,862	8,137		
	FSLIC-insured deposits:													
4	Annual growth rate	---	3.80%	2.34%	2.18%	2.69%	2.78%	4.64%	7.60%	6.00%	3.60%	2.80%		
5	Average deposits for fiscal year	980	1,017	1,041	1,064	1,092	1,123	1,175	1,264	1,340	1,388	1,427		
6	FSLIC premium rate	0.21%	0.21%	0.22%	0.23%	0.23%	0.19%	0.18%	0.18%	0.18%	0.18%	0.18%		
	FDIC-insured deposits													
7	Annual growth rate	---	4.75%	2.93%	2.72%	3.36%	3.48%	5.80%	9.50%	7.50%	4.50%	3.50%		
8	Average deposits for fiscal year	2,350	2,462	2,534	2,603	2,690	2,784	2,945	3,225	3,467	3,623	3,749		
9	Additional FDIC premium rate	0.000%	0.028%	0.059%	0.067%	0.067%	0.067%	0.067%	0.067%	0.067%	0.067%	0.067%		
10	Ratio: Deposits to nominal GNP	65.3%	65.1%	65.0%	64.9%	64.8%	64.7%	64.5%	64.1%	63.9%	63.7%	63.6%		
	Interest rate assumptions:													
11	Rate on 30-year Treasuries	9.20%	8.80%	8.15%	7.70%	7.50%	7.30%	8.00%	9.08%	9.08%	8.54%	8.00%		
12	REFCORP bond rate (weighted average)	9.45%	9.09%	8.86%	8.79%	8.79%	8.79%	8.79%	8.79%	8.79%	8.79%	8.79%		
13	FICO bond rate (weighted average)	9.87%	9.66%	9.56%	9.56%	9.56%	9.56%	9.56%	9.56%	9.56%	9.56%	9.56%		
14	Assumed interest rate on FSLIC notes	8.10%	7.80%	7.30%	6.50%	6.10%	5.90%	6.90%	8.68%	8.08%	7.68%	7.28%		
15	- Spread over thrift cost of funds	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%		
16	+ Implied thrift cost of funds	7.60%	7.30%	6.80%	6.00%	5.60%	5.40%	6.40%	8.18%	7.58%	7.18%	6.78%		
17	FICO bonds outstanding -- start of fiscal year	3.75	7.50	10.83	10.83	10.83	10.83	10.83	10.83	10.83	10.83	10.83		
18	REFCORP bonds outstanding -- start of fiscal year	0	10	35	50	50	50	50	50	50	50	50		
	FSLIC cash inflows:													
19	FHLB retained and future earnings	0.8	1.1	0.8	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	4.3	
20	S&L premiums	2.0	2.1	2.3	2.4	2.5	2.2	2.1	2.3	2.4	2.5	2.6	25.5	
21	- Secondary Reserve recovery	(0.1)	(0.1)	(0.1)	(0.1)	(0.3)	0.0	0.0	0.0	0.0	0.0	0.0	(0.7)	
22	Sale of FICO bonds	3.75	3.33	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	7.1	
23	Sale of REFCORP bonds	10.0	25.0	15.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	50.0	
24	Total cash inflows	16.5	31.4	18.0	2.5	2.4	2.4	2.3	2.5	2.6	2.7	2.8	86.2	
	FSLIC expenditures (budgetary accounting)													
	Pre-1/1/89 cases:													
25	FSLIC notes issued during FY 89	9.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	9.7	
26	Interest on FSLIC notes ($19.7 bil. initially)	1.4	1.5	1.3	1.2	1.1	1.0	1.2	1.3	1.2	1.2	0.3	12.6	
27	Repay notes issued prior to FY87	0.0	0.0	0.2	0.0	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.5	
28	Assistance agreement payments	5.2	4.4	3.8	4.2	3.4	2.9	1.0	1.0	1.0	1.0	1.0	28.8	17.5

Cash flow summary -- undiscounted basis:

Uses of cash:	
Net outlays on pre-1989 cases	48.3
Net outlays on post-1988 cases	62.0
Interest - FICO and REFCORP bonds	52.2
Purchase of zero-coupon bonds	4.3
Total cash outlays	166.8
Sources of cash:	
Earnings from FHLBs	4.3
Premiums paid by S&Ls	24.8
Bond sales - REFCORP and FICO	57.1
Total cash receipts	86.2
Net FSLIC outlays	(80.6)
- FDIC tax (premium) offset	19.0
Net budget outlay	(61.6)
- Omissions from Treasury projection	(6.0)
Net budget outlay after omissions	(67.6)

Size of problem solved, in present value terms:	
FSLIC notes outstanding - 12/31/88	19.2
Assistance agreements O/S - 12/31/88	17.5
Clean up of insolvents at 1-1-89	32.0
Total based on Treasury assumptions	68.7

Exhibit 4 - Page 1

		FY89	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY 89-99	
29	Liquidations - 10/1-12/31/88	1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.0	
30	FSLIC operating expenses	0.3	0.3	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.2	0.2	2.8	
31	- Other old collections (except FICO bonds)	(0.9)	(0.9)	(0.8)	(0.7)	(0.9)	(1.0)	(0.4)	(0.4)	(0.4)	(0.4)	(0.4)	(7.1)	
32	Net outlays - pre-1/1/89 cases	16.7	5.3	4.8	5.1	4.1	3.2	2.0	2.1	2.0	2.0	1.1	48.3	
	Post-1988 resolutions:													
	S&Ls insolvent on 1/1/89 - RTC cases													
33	Assisted mergers	5.0	12.5	7.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	25.0	
34	Liquidations	5.0	12.5	7.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	25.0	
35	- Receivership collections	0.0	(0.5)	(1.8)	(2.5)	(2.5)	(2.0)	(0.8)	0.0	0.0	0.0	0.0	(10.0)	
36	Net spending - RTC cases	10.0	24.5	13.3	(2.5)	(2.5)	(2.0)	(0.8)	0.0	0.0	0.0	0.0	40.0	32.0
37	S&Ls insolvent after 1/1/89 (post-RTC cases)	0.0	0.0	2.0	2.4	3.6	2.0	2.3	2.6	2.8	3.0	3.3	24.0	
38	- Receivership collections	0.0	0.0	0.0	(0.1)	(0.2)	(0.4)	(0.5)	(0.4)	(0.3)	(0.1)	0.0	(2.0)	
39	Net spending - post-RTC cases	0.0	0.0	2.0	2.3	3.4	1.6	1.8	2.2	2.5	2.9	3.3	22.0	
40	Expected losses as a % of deposits			0.19%	0.22%	0.31%	0.14%	0.15%	0.17%	0.19%	0.21%	0.23%		
41	Post-1988 resolution spending - Net	10.0	24.5	15.3	(0.2)	0.9	(0.4)	1.0	2.2	2.5	2.9	3.3	62.0	
	Interest expense:													
42	FICO bonds	0.6	0.9	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	10.8	
43	REFCORP bonds	0.5	2.0	3.8	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.4	41.4	
44	Total interest expense	1.0	2.9	4.8	5.4	5.4	5.4	5.4	5.4	5.4	5.4	5.4	52.2	
45	REFCORP defeasance (purchase of zeros)	0.7	2.1	1.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	4.3	
46	Total expenditures	28.5	34.8	26.3	10.3	10.4	8.2	8.5	9.7	10.0	10.3	9.9	166.8	
47	Net outlays for FSLIC (budget impact)	(12.0)	(3.3)	(8.3)	(7.7)	(8.0)	(5.9)	(6.1)	(7.3)	(7.3)	(7.6)	(7.1)	(80.6)	
48	- Budget offset effect of additional FDIC tax	0.0	0.7	1.5	1.7	1.8	1.9	2.0	2.2	2.3	2.4	2.5	19.0	
49	Net budget outlay (including additional FDIC tax)	(12.0)	(2.7)	(6.8)	(6.0)	(6.2)	(4.0)	(4.2)	(5.1)	(5.0)	(5.2)	(4.6)	(61.6)	
	Omissions from Treasury projection:													
50	Impact of corporate tax offset of higher DI tax	0.0	(0.2)	(0.5)	(0.6)	(0.6)	(0.5)	(0.5)	(0.6)	(0.6)	(0.6)	(0.7)	(5.4)	
51	Defeasement of new FICO bonds	(0.3)	(0.3)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	(0.6)	
52	Net budget outlay after inclusion of omissions	(12.2)	(3.2)	(7.3)	(6.6)	(6.8)	(4.5)	(4.7)	(5.7)	(5.6)	(5.8)	(5.2)	(67.6)	
53	- Net budget outlay as reported in Treasury proj.	(11.1)	(1.9)	(6.0)	(3.8)	(3.7)	(1.5)	(1.9)	(2.6)	(2.6)	(2.6)	(2.2)	(39.9)	
54	Net increase in outlay from Treasury projection	1.1	1.3	1.3	2.8	3.1	3.0	2.8	3.1	3.0	3.2	3.0	27.7	
55	Memo: Net budget outlay, per 1990 Reagan budget	(8.7)	(2.1)	(6.6)	(4.9)	(4.9)	(3.4)							

Chairman ROSTENKOWSKI. Thank you, Mr. Ely.
Ms. Ettleson.

STATEMENT OF SHERRY ETTLESON, STAFF ATTORNEY, PUBLIC CITIZEN'S CONGRESS WATCH

Ms. ETTLESON. Thank you.

Mr. Chairman, members of the committee, on behalf of Public Citizen, a national consumer and environmental advocacy group, I appreciate the opportunity to testify before you today.

I commend the committee for its willingness to consider what is in fact the most important issue in the savings and loan bailout, who is going to pay and how?

The Bush plan is severely regressive and unfair, and unfortunately, with the rush to enact legislation, this fundamental issue is receiving little attention.

As members of the committee with authority over debt management, it is up to you to take the first steps to make this bailout fair by ensuring depositors—by ensuring that depositors and small taxpayers are not asked to pay the bill for agency failure and insider misdealing and fraud.

The combination of reckless deregulation, agency failure, and insider misdealing and fraud has led the savings and loan industry to collapse. Average citizens neither caused nor benefited from the policies that have lead to this crisis. Most people are net debtors and thus suffer when real interest rates rise. There is little benefit in earning higher interest rates on their savings accounts when they are overwhelmed by higher interest rates to buy homes, cars, and pay off their credit card bills.

Two principles should be paramount in determining the funding for this plan. The costs should not be disproportionately placed on those least able to pay and those least culpable, and it should be done in the least expensive form of borrowing.

The Bush plan is both inequitable and needlessly expensive. Under the plan, small savers are essentially asked to pay twice, once as taxpayers and again as depositors, as increased premiums are passed through to small- and moderate income depositors.

The Bush plan proposes using an on-budget agency to recapitalize FSLIC. But this quasi-governmental Rube Goldberg machine is the wrong way to fix this crisis. It will spend more money to pretend it is spending less. It unnecessarily delays and prolongs the bailout, and it makes a mockery of the notions of budget accountability.

RefCorp is a shell corporation controlled by the Government and the funds will be implicitly or explicitly guaranteed by the Government. Congress should make sure that not only those who contributed to this crisis are held accountable by making them pay the costs of the bailout, but also ensure that the Government is held accountable in budgetary affairs.

This proposed quasi-governmental agency should be scrapped. Bonds for the bailout should be issued by Treasury itself. The bailout should be completed within 10 years. And finally, the cost of the bailout should be borne by those responsible, financial institutions, corporations, and the wealthy.

Corporate America should be held accountable for its actions. We must stop socializing losses and privatizing profits, and we must stop fooling ourselves and reestablish integrity into the budgetary process.

Thank you.

[The statement of Sherry Ettleson follows:]

TESTIMONY OF
SHERRY ETTLESON,
STAFF ATTORNEY,
PUBLIC CITIZEN'S CONGRESS WATCH
BEFORE THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
APRIL 18, 1989

Mr. Chairman, Members of the Committee: We appreciate the opportunity to testify before you today. Public Citizen is a national consumer and environmental advocacy organization, based in Washington, D.C.

We commend the Committee for its willingness to consider what is in fact the most important issue in the savings and loan bailout -- who is going to pay for it, and how. The Bush bailout plan contains elements that are severely regressive and unfair. Unfortunately, in the rush to enact legislation to stanch the hemorrhaging S&L system, these fundamental issues are not receiving adequate attention.

As members of the House committee whose authority encompasses financing and spending mechanisms, it will be up to you to take the first steps at making this a fair bailout by ensuring that depositors and small taxpayers are not asked to pay the bill for agency failure and financial fraud.

I. THE CAUSES OF THE CRISIS

The unfairness of the proposed funding scheme is clearest when the causes of the crisis are understood. A combination of reckless deregulation, agency failure and rampant insider misdealing and fraud has led the savings and loan industry to the brink of collapse.

First, thrifts -- special purpose institutions given special public benefits in return for a focus on housing capital -- successfully broke free of traditional regulatory restrictions. This deregulation was part of a general trend of financial deregulation, which saw heretofore staid financial institutions pay sky-high interest rates -- and make increasingly risky investments to fund those interest payments.

Second, most thrift failures involve personal misconduct on the part of officers and directors. The General Accounting Office (GAO), before the House Judiciary Committee in March of this year, went so far as to call white-collar crime the main cause of the crisis. "The bulk of the losses are directly attributable to the failure by management of a minority of the industry to follow basic prudent business practices, including the establishment of effective systems of internal control," the agency reported. In a similar vein, regulators have reported that crime was a factor in 70 percent of insolvent institutions.

Finally, both free-wheeling investments and corrupt management were abetted by lax regulators. According to Don Brumbaugh, the FHLBB's chief economist from 1983-1986:

> The result [of S&L industry influence over regulatory agencies] in the 1980s has been the selection of regulatory approaches that have favored the short-term interests of existing thrift institutions at the expense of consumers of financial services, society in general, and even the long-term interests of stockholders and employees of those thrift institutions that will ultimately survive.

Average citizens neither caused nor benefitted from the polices that led to the industry's collapse.

They did not benefit, of course, from the widespread looting of the thrifts reported by the GAO and others. And most citizens did not benefit from the unprecedented wave of financial deregulation that prompted the savings and loan crisis. Those in upper economic brackets did benefit from these policies, through higher interest payments and expanded investment choices. But most families are net debtors, who suffer when real interest rates rise. Whatever benefits they gain from greater interest on savings accounts was overwhelmed by the higher interest they had to pay on their houses, their car, their credit card or their student loan.

THE BUSH BAILOUT PLAN: SOAKING THE SMALL TAXPAYER AND DEPOSITOR

The cost of the bailout is now estimated at a staggering $157 billion and rising. President Bush's bailout proposal places heavy burdens on taxpayers and consumers s and consumers. As the true cost of the bailout balloons in future years, taxpayers will suffer even more. Hence, two principles should be paramount in determining the funding of the plan. First, the cost of the bailout should not disproportionately burden those who least able to contribute and are least culpable. Second, the least expensive form of credit possible should be used.

The Bush bailout plan is both inequitable and needlessly expensive. In a futile effort to blink away the enormity of the problem the Bush plan will cost more than it should. And it unnecessarily and regressively places a heavy burden on the middle class and the poor. Under the President's plan, small savers essentially will be asked to pay twice: once as a taxpayer and again as a depositor (in the form of increased fees for checking and other accounts).

A. FUNDING THE BAILOUT THROUGH GOVERNMENT SPONSORED ENTERPRISE

The Bush administration proposes to fund the FSLIC recapitalization largely through a Rube Goldberg scheme of government sponsored enterprises and off-budget corporations. The scheme's primary goal, evidently, was to minimize accountability to the public. Perversely, the plan proposes to spend <u>more</u> to pretend it is spending <u>less</u>.

It proposes creating the Resolution Financing Corporation (REFCORP), and off-budget agency to fund a large portion of the bailout. REFCORP would borrow $50 billion in FY 1989, 1990, and 1991. The principal on the REFCORP bonds would be paid for by purchasing U.S. Treasury zero coupon bond that would be worth $50 billion upon maturity.

The cost of the bailout is already staggeringly high: according to the most recent projection of the House Banking Committee, <u>$158 billion</u>. Unfortunately, the REFCORP scheme adds billions of dollars in cost to the bailout, for three reasons.

First, interest payments on REFCORP's debt would be paid mostly from the Treasury. Financing such interest payments with additional debt would cause the cost of the overall bailout to grow at a compounded rate adding to the already overwhelming deficit. Moreover, since REFCORP's bonds will not be backed by the full faith and credit of the United States, it is likely that

interest payments will be higher than if they had been issued by the Treasury. This difference, too, must be made up by the taxpayer. The Chairman of the Federal Reserve, Alan Greenspan, and other financial analysts estimate that REFCORP bonds will require a 30 basis point premium over Treasury interest rates.

Second, the Bush administration proposes to unnecessarily prolong the bailout, stretching it out over 30 years. This slow-motion solution adds billions of dollars in interest costs that would be avoided if the problem were fully faced now. In fact, the true cost of the bailout is likely to be substantially higher than current projections. For example, the Bush plan assumes unrealistically low interest rates (four percent) and overoptimistic economic scenarios. Those additional costs, in turn, will likely be borne by taxpayers as projected non-governmental funding sources prove inadequate.

Finally, the creation of REFCORP distorts the true size of the budget deficit and makes a mockery of notions of budget accountability. It runs directly counter to the governing principles established by the 1967 President's Commission on Budget Concepts. According to the commission's widely accepted criteria, an enterprise is considered to be off-budget only when it is "completely privately owned." REFCORP fails this test. It essentially would be a shell corporation; its owners would not enjoy the benefits of the enterprise, nor would they bear the risk of loss from the enterprise. The Federal Home Loan Banks, which would make legally mandated nominal contribution to REFCORP, have no rights in the corporation, and would not profit from their contribution.

Instead, REFCORP benefits the government, which would control how and when the entity's funds will be used. The $50 billion debt obligation of REFCORP would have an explicit government guarantee of interest as well as an implicit government guarantee of the principal.

In short, REFCORP is a government corporation. By removing it from the budget and essentially ignoring the 1967 Budget Commission concepts merely to evade the spending limits set by the Balanced Budget Act, perversely the government will spend more money to pretend it is spending less. Worse still, it greatly diminishes the integrity of the budget process.

Who will be fooled? The markets won't be fooled; they know fully well that REFCORP debt effectively adds to government debt. In the end, the Bush scheme is aimed at fooling only one market -- the political accountability market.

B. INCREASED PREMIUMS

Compounding the flaws of the off-budget scheme is the unfairness of another prime funding source for the bailout: the imposition of increased insurance premiums on banks and S&Ls. This method of raising funds guarantees that the cost of the bailout will be distributed unfairly. While levied on financial institutions, these premiums will be passed on to depositors in the form of increased fees. These costs are generally imposed in a regressive fashion -- low- and moderate-income depositors pay a greater percentage of their income than do the wealthy.

A study conducted by the Consumer Federation of America (CFA), and presented to this committee earlier this year, demonstrates the regressivity of funding the bailout through insurance premiums. According to CFA, if insured financial institutions allocate the costs to consumers, the poorest 50 percent of the population who earn about 18 percent of the nation's annual income, would bear 36 percent of the burden. If, on the other hand, the funds are raised through the current income tax system the poorest 50 percent of the population would

bear about 6 percent of the burden. In contrast, the wealthiest 10 percent of the population, who earn about 36 percent of the nation's annual income, would pay less that 10 percent of the burden if financial institutions passed on the deposit premiums increases to consumers.

III. RECOMMENDATIONS FOR RESPONSIBLE AND FAIR FUNDING OF THE BAILOUT

This unprecedented bailout by the federal government should be accomplished through the most efficient method possible with the least financial burden on small depositors and moderate-income taxpayers, who neither caused nor benefitted from this crisis.

The cost of the bailout should be borne by those who benefited from the deregulation of the 1980's. Corporate crime should be paid for by corporate taxes. Financial institutions, the wealthy, and corporations that continue to avoid their fair share of taxes and continue to push for looser controls on the financial industry, should pay the heaviest burden to clean up the thrift industry. The more corporate America asks Congress to socialize its losses while privatizing profits the more the U.S. will begin to lose its competitive edge.

* First, the proposed quasi-governmental entity to sell bonds to fund the bailout should be scrapped. Instead, bonds to fund a bailout should be issued by the Federal Treasury itself, at an estimated savings to the taxpayers of at least $4.5 billion over the next thirty years. Even though it would save the public money, this proposal runs up against the budget ceilings imposed by Gramm-Rudman-Hollings -- thus validating critics' concerns that the deficit reduction scheme would prove to be a fiscal straightjacket. To surmount this self-created obstacle, Congress should suspend Gramm-Rudman for the purpose of paying for the cleanup. Alternately, REFCORP could be retained, but considered an "on-budget" entity.

* Second, the bailout should not be stretched-out over thirty years; instead, it should be completed within a decade. Such a change would save substantial sums in interest over time. And it has the advantage of forcing Congress to address real-world budgetary impact of this proposal, rather than partaking in a government wide game of blame avoidance.

* Finally, with the bailout on budget, Public Citizen urges the Congress to ensure that its cost be borne by those most responsible -- the financial industry, the wealthy, and corporations. We have suggested several ways to do this. For example, special tax treatment for leveraged takeovers and buyouts should be eliminated, a surtax on the Casino Economy should be levied, the minimum corporate tax should be strengthened, and the flaws in tax reform should be remedied and the top individual income tax rate should be raised.

IV. CONCLUSION

At its core, the issue before the Committee and the Congress is one of accountability. Lack of accountability was the downfall of the industry that is being bailed out. As guardians of budget purity it is up to the Committee and Congress to face up to fiscal reality and act responsibly to establish an equitable solution to this crisis.

Chairman ROSTENKOWSKI. Thank you.

Are there any questions of the witness?

Mr. Gradison.

Mr. GRADISON. Thank you, Mr. Chairman.

Mr. Chairman, I guess I approach this basically from two points of view: first, trying to keep down the costs of the bailout, and the second, trying to minimize the chance of having the same problem arise again in the future. I think those are the two things that bother me the most about the overall issue. Those are the criteria that I'm trying to use in thinking my way through this.

When I look at the experience that we've had with FSLIC and with the farm credit agencies, among others, the question of course arises: How do we get into these situations? Is there a way to avoid them? Is there something we have been doing wrong? Or is this inherent in trying to favor certain types of borrowers and thereby setting up specialized, industry-specific lending institutions rather than relying upon the general marketplace with more diversified lenders like commercial banks or insurance companies to participate.

I would welcome the comments of any of the panelists on this, but just to start it off, I would perhaps just like to ask Dr. Seidman, is there a way to avoid these problems?

Mr. SEIDMAN. Yes. I think every one of these problems could have been anticipated. There has been failure all around, both of the process in dealing with it and using the means provided under the Government Corporation Control Act, which has been neglected—although there are some deficiencies in the Control Act which I've pointed out in my statement—and also the political will to do something about it.

As I indicated in my statement, when President Eisenhower proposed to amend the Government Corporation Control Act, it was to get at this very problem. He was concerned with mixed-ownership corporations, which then were the equivalent of the GSE's, and many of them have become GSE's.

And I recall when I was a witness for the administration before the committee, they asked why they should be concerned? And this was in 1959. And I said, well, the farm credit banks are lending money at lower interest rates than they are borrowing. At some time the banks are going to present a bill to the Congress to pay the difference.

It requires not only reform of the process and procedure but building up staffs within the Office of Management and Budget, and the Appropriations Committees who are competent and interested in evaluating and analyzing business-type statements and not playing with the numbers. The numbers have become their own purpose.

And I think we're dealing here with issues which are fundamental. The pending S&L legislation is merely illustrative of a much bigger problem, which could lead to disintegration of our governmental system, and maintenance of responsible and accountable Government.

We have talked a great deal about how we bailout these institutions. I think we need to give equal attention to how to we avoid

having the same situation occur again. And occur it will, unless we change.

Mr. GRADISON. Mr. Stanton.

Mr. STANTON. Congressman Gradison, financial institutions generally have perhaps three kinds of risk. They run credit risk, what's the quality of the loans they make; interest rate risk, to what extent are they playing term intermediation in taking a risk on interest rates the way the thrifts did most dramatically, but also Fannie Mae; and finally, management risk, including operations risk. If you're a Fannie Mae with $290 billion of assets and mortgage-backed securities, how well do you manage that operation, particularly if you're growing by over $40 billion a year. In addition, there are other kinds of risk such as sectoral risk and so forth.

As a practical matter, banks can diversify their lending, into commercial loans, foreign loans, agricultural loans, real estate loans, have a cushion when they take certain kinds of risks, because not all of those kinds of loans entail the same kinds of risk. However, banks have also been in trouble. And I would have to say that the problem of the thrifts, although exacerbated by their single-sector concentration on mortgage loans was not solely due to that concentration.

Instead what we can point to—and it goes to Dr. Seidman's point about accountability—is that in all of these institutions people are playing with the Government's guarantee, either implicitly through insured deposits or, in the case of the Government-sponsored enterprise, through the implicit guarantee of enterprise obligations. And they often play with relatively little money of their own.

Only belatedly, only now are we looking to impose risk-based capital requirements. If you observe the actions of the House Banking Subcommittee, they have seriously weakened capital requirements for thrifts. And then we will be surprised when thrifts go out and take high risks again. If you look at the current bill, you will find there are no risk-based capital requirements any place for any of the Government-sponsored enterprises.

In addition to capital, so that people are playing with their own money and not just leveraging the Government guarantee, you need effective regulation of safety and soundness. You need a regulatory agency acting like a private creditor that says we are lending the Government's guarantee here, and we are going to police to make sure these institutions stay safe and sound and don't become insolvent so we take a huge loss.

Mr. ELY. Congressman Gradison, I would echo and add to these comments.

I can assure you that this problem will come up again in roughly 3 to 5 years. We have to understand that Federal deposit insurance always has been actuarially unsound, and there's nothing in the present legislation to correct that. The present legislation will preserve an industry, the thrift industry, that has outlived its usefulness, it will preserve an industry that will continue to substantially mismatch interest rate and it will preserve an industry where one-third of its members will go forward into the 1990's either insol-

vent as a practical matter or in fact skating on very thin capital ice.

I don't think we can count on the Federal Government to be able to control the risk-taking of these institutions because the political process tilts towards those who are faring badly under the present system. We see this so clearly in terms of the lobbying clout of the weak thrifts in terms of their being able to get their way on capital standards. The weak thrifts are being much more effective in this lobbying effort than the strong financial institutions that would like to see tougher capital standards.

We then add into this stew the growing ineffectiveness and the declining efficacy of financial services regulation, throw all of this together in a pot, and 3 to 5 years from now we'll be back talking about these same issues again.

Mr. GRADISON. Well, thank you for those very sobering comments. I believe my time has expired.

Thank you, Mr. Chairman, for your patience.

Chairman ROSTENKOWSKI. Mr. McGrath.

Mr. MCGRATH. Thank you, Mr. Chairman.

Let's assume that we agree with you and are able to bring this borrowing on budget. Could you tell me what percentage of the long issues this $50 billion represents, and can you guess at what it might do to the interest rates in this category of issue?

Mr. ELY. First of all, it's important not to borrow long term. Initially we should be borrowing short term because these funds will be used effectively to liquidate short-term deposits in the thrift industry. What we want to do is redenominate as Federal debt $50 billion of short-term debt in this country now held by thrifts.

Only over a period of time should we then slowly roll that short-term Federal debt out into a longer-term Federal debt. To go out immediately with long-term debt is going to have a serious, adverse impact on the debt market. In the last 3 years the Federal Government has issued about $97 billion of 30-year Treasury debt. If we're going to go out and issue that much debt over the next 3 years for general debt purposes, and then add on to it $50 billion of RefCorp debt, then we're going to be distorting the long end of the interest yield curve and not just for Government debt, but for corporate debt and also for home mortgages since so many fixed-rate mortgages are now securitized and sold in the same debt market.

So I think the important thing to do is to go short term, not long term, in initially funding the FSLIC cleanup.

Mr. MCGRATH. Well, if we should accept your advice and go short, how short, number 1, and number 2, how many times should we roll this over before we start issuing either intermediates or longs?

Mr. ELY. I think that the short term is going to be a function of anywhere from 3 months to 2 or 3 years. What should govern the initial financing maturities are the maturities of the deposits coming out of the savings and loans that will be reintermediated into the financial markets. That is, if people get money back from savings and loans because an S&L has been liquidated or because savings and loans are going to shrink themselves, these depositors are going to put that money into the Government debt market or

into money market mutual funds or other short-term avenues of investment.

Therefore, there should be a range of maturities of Government debt issuance that try as best as possible to match the maturities in which former S&L depositors are reinvesting their funds so that we will have as little impact on the debt yield curve as possible. I can't give you a precise breakdown of these debt maturities. My estimate is that they should range from 91-day Treasury bills to no more than 3-year Treasury notes.

Mr. MCGRATH. In your opinion then, the cost of reissuing would be something that would be small compared to the long-term effect of going long right away?

Mr. ELY. I think it would be a lot less, even given the inverted yield curve, because the inverted yield curve is not going to last forever. If there's any sense that long-term interest rates are going to come down, then I think it's better to ride out the inverted yield curve for another year or two, at which point in time, once the curve goes back to a positive slope, it's actually going to be cheaper to continue rolling over short-term debt. Then on a gradual basis, Treasury should stretch those maturities out in the context of the overall management of the maturity distribution of the Federal debt.

Mr. MCGRATH. Do you know of any agency in the Government that's qualified to do this?

Mr. ELY. Well, the Treasury has a public debt office. They're the folks who are managing over $2 billion of marketable public debt. This is something that they, in conjunction with the Wall Street community, ought to be able to figure out. I don't think it's that difficult.

Mr. MCGRATH. Thank you.

Chairman ROSTENKOWSKI. Would any of you like to make any comments?

Mr. SEIDMAN. One comment I would make as to the added cost to the Government of borrowing directly in the market rather than borrowing through the Federal financing bank. As it was pointed out, you're going into a competitive market. If they're marketing these directly, they are going to compete with Government, and the net effect can be to inflate the interest costs of borrowing for the Government in general. We're setting up our own competition and it can inflate interest rates.

Now, I can't prove this, but I think this is very likely to occur. This was one reason for having the financing bank, and not allowing agencies to go directly into the market and to compete with borrowing by the Treasury.

Mr. GRADISON. Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Gradison.

Mr. GRADISON. Thank you, Mr. Chairman.

One of the ironies of this is the concept to borrow long and lend short. You're going to borrow $50 billion long, and in effect lend it short. And who gets hurt? The Treasury has to pay some extra interest, but the housing market, which relies on long-term credit probably more than any other part of our economic system, is the one most likely to be hurt by this borrowing strategy. And yet

that's the market that we're supposed to be preserving for the savings and loan industry to assist.

There are some real problems in here that need talking about. And I want to again thank the chairman for giving us this opportunity to explore some of them.

Mr. STANTON. Mr. Chairman, I'd like to add a comment on jurisdiction if I might.

You have heard one witness after another this morning talk about how RefCorp is essentially disguised public borrowing. That is squarely within the jurisdiction of this committee even if the transaction has been camouflaged to look as if it is borrowing by a private institution. Mr. Chairman, members of the committee, I urge you to assert that jurisdiction.

Chairman ROSTENKOWSKI. Thank you very much, ladies and gentlemen. The committee stands adjourned.

[Whereupon, at 2:49 p.m., the hearing was adjourned.]

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